Special Report 2010/03

Impact of new capital proposals from Basel

The credit crisis has led to an accelerated revision of capital requirements for banks. The capital reserves that banks maintain to cover possible losses were exposed by the crisis as being inadequate for many banks. Consequently the Basel Committee on Banking Supervision came up with proposals in June and December 2009 to strengthen the capital requirements for banks and to improve the quality of capital. In this Special Report we focus on these new proposals ('Basel III') and on the history that preceded them (Basel I & Basel II). What do these new requirements mean for the financial sector, and what do they mean for the Rabobank? Will the new capital requirements be able to prevent another crisis?

What are the Basel Accords?

Banks require capital (equity) in order to absorb unexpected losses and thus reduce the risk of insolvency. Capital is therefore needed to ensure the stability of the financial system. However, the costs of holding capital reserves are relatively high because of the required return. Differences between countries in capital requirements and risk weighting criteria for assets lead to differences in the cost of capital for banks. International agreements on these factors are needed in order to prevent unfair competition between various countries and banks. These agreements are contained in the Basel accords.

Basel I

In 1988 the Basel Committee, consisting of international banking supervisors and central bank delegates from the G-10 countries[1] reached the first international agreements on capital requirements for banks. From now on then, the banks would have to hold capital of at least 8% of their risk-weighted assets[2] of which at least 4% would have to be of the highest quality (Tier 1[3]). Basel I focussed only on credit risk: the risk that bank loans would be only partly repaid or not at all. It was implycitly assumed that the 8% capital requirement would be adequate to cover other risks as well. During the 1990s banks were increasingly trading for their own account. Therefore in 1996, market risk (the risk that a bank incurs on its trading portfolio) was explicitly included in the capital requirements.

Where Basel I fell short

Over time, criticism of Basel I grew louder. The main bone of contention was that the risk weighting of assets did not reflect the large divergence of risks to which different banks were exposed. Under the Basel I accord many loans were categorised in the very broad 100% bracket, whereas in practice, there is considerable variety in degree of credit risk. This resulted in a preference among banks for relatively high-risk assets over lower-risk instruments, because the capital requirement was the same. The expected return on equity could thus be optimalised, as risk and return are positively correlated under normal circumstances. The downside of this was increased vulnerability of bank balance sheets. Other criticism of Basel I was related to the limited scope of only targeting credit and market risk.

Basel II

In 2004, after years of deliberation, the Basel II accord was presented – an improved

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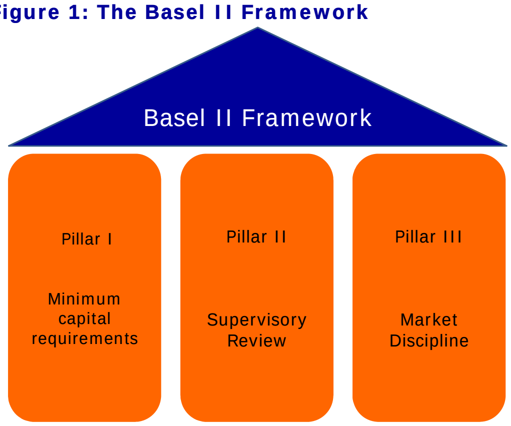
[1] Belgium, Canada, Germany, France, Italy, Japan, Luxembourg, the Netherlands, Spain, the U.K., the U.S., Sweden and Switzerland.

[2] Bank assets were divided roughly into risk categories of 0%, 20%, 50% and 100% before the 8% capital requirement was applied.

[3] Tier 1 capital is the bank's core capital and is thus the most secure capital. Banks also have Tier 2 and Tier 3 capital as supplementary reserves of less high quality. This capital permits the bank to absorb fewer risks than Tier 1 capital.

agreement based on a 'three pillars' concept. This agreement took effect in 2008 in the European Union by means of the EU Capital Requirements Directive.

Figure 1: The Basel II Framework



Source: Rabobank

In the *first pillar*, greater risk sensitivity of regulatory capital reserves ensures that the capital will better reflect the risks to which the banks are exposed in practice. Operational risk is now explicitly included in the requirements, and banks may use internal risk models to measure risk. The 8% requirement in respect of this amended risk weighting remains unchanged. The *second pillar* concerns the supervisory review of the internal risk management processes and the required amount of economic capital calculated by the bank to cover all material risks. This oversight also includes the internal risk management processes for risks that are not explicitly catered for in the first pillar, such as interest rate risk, liquidity risk and concentration risk. If necessary, the supervisor may enter into discussion about this with the bank in question, and may impose a higher capital requirement than that stipulated by the first pillar. The *third pillar* obliges banks to publish relevant information about their risk profile and capital position. High-risk behaviour may thus be curbed: the market may for instance demand higher interest rates from banks that have relatively more exposed credit portfolios.

Basel III: Additions to Basel II

The credit crisis clearly showed the shortcomings of the Basel II accord. Banks' capital reserves were too low in a number of cases, not all risks had been identified, and financial innovation meant that new complex products were not covered by the regulations of Basel II. For example securitisation[4], meant that increasingly greater credit risk was being taken in the trading book[5], because the capital requirement was much lower than for the banking book. Therefore, in July 2009, the first supplementary proposals to Basel II were presented.[6] These reforms will raise capital requirements for positions in the trading book and complex securitisation exposures (so-called resecuritisations), and will take effect from 31 December 2010.

The risks attached to securitisation had been insufficiently addressed in Basel II, and many internationally operating banks incurred heavy losses from these activities during the crisis.

In December 2009 further proposals were made by the Basel Committee towards strengthening the capital framework[7]:

- Raising the quality of the capital base
- Enhancing the risk coverage of capital requirements
- Introduction of the 'leverage ratio'
- Reducing procyclicality
- Addressing systemic risk

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[4] Securitisation means cutting up and bundling together loans that are then sold on to an off-balance sheet 'special purpose vehicle' (SPV). The SVP raises the money for this by issuing debt instruments (with the chopped up loans as collateral) on the capital market.

[5] In the bank book assets are retained until their term expires, whereas the trading book lists tradable instruments, including off-balance sheet activities. Besides liquidity risk, the main risk in the bank book is interest rate risk, whereas in the trading book it is market risk.

[6] See the July 2009 consultative papers of the Basel Committee on Banking Supervision, *Enhancements to the Basel II framework and revisions to the Basel II market risk framework*.

[7] See the December 2009 consultative papers of the Basel Committee on Banking Supervision *Strengthening the resilience of the banking sector.*

In a further consultative paper the Committee also puts forward proposals for harmonisation and upscaling of liquidity oversight, which will have a considerable impact.[8] We will examine this in a future Special Report.

Raising the quality of the capital base

The crisis demonstrated that only high-quality capital that is directly and fully available can be used to absorb losses as they occur. In many banks this capital base was inadequate. The Basel Committee therefore believes that the bulk of a bank's capital base must be of the highest quality. In the case of listed companies, this capital consists of share capital and retained earnings. For cooperative banks such as Rabobank, the capital is composed of retained earnings, member certificates or cooperative shares.[9] The Basel Committee also wants to simplify the definition of capital and its structure, reducing it from three Tiers to two Tiers.

Enhancing the risk coverage of capital requirements

Counterparty risk exposure is the credit risk that arises from derivative transactions. This risk turned out to be very real for parties such as Lehman Brothers, AIG and Bear Stearns. One of the reforms proposed by the Basel Committee is a new capital requirement for the risk to banks associated with a deterioration of the credit-worthiness of a counterparty. The new proposals will also contain incentives for banks to move bilateral derivative contracts to multilateral clearing through central counterparties. These parties support the standardisation and settlement of contracts, thus reducing systemic risk.

Leverage ratio as a supplementary measure

The 'leverage ratio' is the ratio between the risk-weighted assets and the amount of equity owned by a bank. The Basel Committee wants to establish a leverage ratio requirement that is intended to curb the build-up of excessive leverage in the banking system - one of the underlying causes of the crisis. However, the question is whether one leverage ratio is enough. Because banks have different business models, the ratio for some banks will have a restrictive effect, but not for others.

Reducing procyclicality

Risk-sensitive capital requirements ensure that a bank's capital base reflects the risk exposure of a bank. However, they have an inherent weakness. In times of economic downturn the risks increase and banks have to hold more capital. Banks can then lend less credit, exacerbating the cyclical downturn. During a cyclical upturn the opposite is the case, and sometimes excessive credit is extended. The Basel Committee has made a number of proposals to reduce this procyclicality. One example is to establish counter-cyclical capital buffers. This means that during the good times banks would build up a capital buffer that could be drawn on in times of stress. In Spain banks are already doing this and are being held up as an example to emulate in Europe.

Addressing systemic risk

Some banks are so important within the financial system, on account of their size, complexity and interconnectedness with other banks that they may be regarded as being 'too big to fail'. Because this possibly leads to more risk taking[10], the Basel Committee is examining the desirability and scope for an additional capital requirement for these 'system banks'. The question is whether this is justified. Large banks are more easily able to diversify their activities, which reduces their risk exposure.

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[8] See the December 2009 consultative papers of the Basel Committee on Banking Supervision, *International framework for liquidity risk measurement, standards and monitoring.*

[9] Rabobank does not issue cooperative shares, although many other cooperative banks do so. See Rabobank (2008), De Rabobank Dichtbij [*Rabobank Up Close*], pp.88-89.

[10] See for example: Stern, G. and R. Feldman (2004), *Too big to fail: the hazards of bank bail outs*, Washington, The Brookings Institution.

And during the crisis it was often smaller banks that got into difficulty.

Consultation period until mid-April 2010

The financial sector has until mid-April to respond to the Basel proposals. In the meantime, the Committee will conduct an assessment of the impact of the proposals on the financial sector. This quantitative study should produce information which will enable the proposals to be further defined, with a view to creating a new framework by the end of the year.

Impact of the new Basel proposals

The aim is to implement the new proposals by late 2012. The proposals have found favour in the political arena, because the higher capital requirements will improve the capacity of the bank to absorb unexpected losses. After all, the tax payer should be protected from the costs of another crisis. Yet, question marks remain over a number of issues. First, the additional proposals are expected to greatly increase the capital requirements. If this reform is not phased in properly, the banks will have to tighten lending, which will put the brakes on economic growth. Secondly, the more stringent capital requirement will make credit more expensive. Therefore the timing of the introduction of the reforms is essential, and must not stand in the way of global economic recovery.

A further question is to what extent will banks be able to raise the extra capital. The introduction of the new requirements means that banks will simultaneously be looking for additional capital. This rise in demand will have an upward effect on the price. Banks will have to increase their profits to become an attracttive option for potential investors. At the same time, there will be political pressure to reduce the risk profile of banks – and hence inevitably their earnings. In addition, the expected increasing domestic competition among banks will put pressure on profit margins. It is therefore questionable whether investors will be prepared to put up with lower returns.

Finally, it is important that strengthened capital requirements should not be understood to be a synonym for a safe and stable financial system. A strong capital base can only serve as a buffer for unexpected losses, but cannot prevent the problems that lead to these losses. This requires proper risk management and oversight.

Impact for Rabobank

Rabobank is preparing in advance for the likelihood that it too will have to hold more capital as a result of the new requirements. Compared to listed companies, Rabobank has fewer possibilities for quickly sourcing external capital. As a cooperative bank it cannot issue shares and is dependent on retained earnings and member certificates. Incidentally, it is not easy for listed banks either to raise capital currently. Suppliers of capital have become very critical. One consequence of the more stringent capital requirements is that Rabobank will have less liquidity available for lending. This means making choices about where growth may or may not take place. Priority will be given to businesses that are important to the clients of the local branches and which fall within the international Food & Agri strategy.

Conclusion

The proposals made by the Basel Committee in late 2009 will in any case mean that banks will have to retain more capital. These requirements will benefit financial stability, because banks will be better able to absorb losses. The timing and phasing in of the requirements needs to be carefully executed in order to limit undesirable effects. Proper risk management and supervision remain necessary. A greater capital base may well absorb losses but cannot prevent them.

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