Issues at stake following the announcements on Basel 3 measures

1. The financial crisis is leading to radical reforms of the prudential requirements for banks

a. Improving the resilience of financial institutions

The recent Basel III agreement has put in place prudential requirements intended to create more resilient institutions. These measures include:

- Substantially raising the quantity, quality, consistency, and transparency of the Tier 1 capital base.
- Introducing a leverage ratio as a backstop to the Basel II risk-based framework.
- Introducing an additional capital conservation buffer to ensure that banks and supervisors take prompt corrective action and that banks can absorb losses during periods of financial and economic stress.
- Introducing a countercyclical buffer, which would be at its maximum in periods when credit is growing rapidly and system-wide risks are rising.
- Looking into an additional requirement for systemically important banks

b. Ensuring that banks and their supervisors effectively cover all the types of risks identified to date

Moreover, the Basel Committee had adopted a series of measures:

- Many improvements have been made to the approaches for assessing risks relating to market operations: the stressed VAR has supplemented the VAR, the Incremental Risk Charge (IRC) covers the risks of losses linked to the deterioration in the counterparty risk for issuers of portfolio assets, the Credit Valuation Adjustment (CVA) covers the risks relating to the deterioration in the counterparty risk for transactions on derivatives, and lastly the treatment of risks on securitisation operations has been improved paying close attention in particular to the risks of off-balance sheet operations.
- Liquidity ratios have been introduced: at global level, new regulatory provisions are introducing a standardised approach for assessing the liquidity risks of banking groups and setting the requirements for holding liquid assets.
- Mechanisms are being put in place reducing the inherent pro cyclicality of existing prudential requirements based on "snapshot" assessments of asset risks: the risks may now be provisioned based on the possible additional losses and not only on the proven losses . This provisioning approach may be considered as more advanced since under stressed conditions it is easier for a bank to offset losses[1] allocating available provisions than to envisage capital reductions.

c. Reducing the interconnectedness between institutions and markets

Following the G20 decisions, the Basel Committee proposed regulatory requirements to build robust financial markets by improving infrastructures and transparency. The regulators proposed to reinforce clearing and settlement processes and the ransparency for all transaction introducing central clearing counterparties for repos and standardised OTC derivatives that act as firewalls against the propagation of default shocks across major market participants and enable authorities to require through-the-cycle margins intended to reduce boom-bust cycles.

In addition to changes to market infrastructure, staged-intervention regulatory regimes, "living wills" for banks, contingent capital and better cross-border resolution regimes should contribute towards reducing crisis spill-over.

2. These reforms are going to significantly impact the mechanisms for financing economies, particularly in Europe

a. The announcements made by the Basel Committee are leading to a very significant tightening of the prudential requirements for banks:

1. Core tier one is moving from 2% to 7% of risk weighted assets (RWA). In view of the new more restrictive definition of the instruments that now constitute the core tier one, it is in reality multiplied by 5.
2. By combining these constraints with the stricter assessment of RWA, the core tier one demanded for trading activities has been multiplied by more than 15.
3. The August 2010 impact analysis published by the Financial Stability Board's Macroeconomic Assessment Group and the Basel Committee on Banking Supervision is forecasting 25% growth in the liquid assets held by banks.

The staggering of moves to roll out the new requirements over a limited number of years is certainly welcome in terms of reducing their short-term macroeconomic impacts. However, most banks consider, unlike the supervisors, that this staggering will not be enough to sufficiently reduce their permanent impact on the economy (risk of less dynamic and more expensive financing):

b. The feasibility if the reforms is contentious

- More specifically, the additional masses of capital required represent in Europe an amount that is equivalent to several times (10) the usual annual volume of the equity issued by the banking sector, set against a backdrop in which the new capital quality requirements are going to prohibit hybrid debt financing. Some consider that each additional point in the core tier one ratio leads to an increase in the global industry's capital of 500 billion euros.
- Without a doubt, it will be more difficult for financial institutions to raise this capital that is required as a result of the dilution-risk for investors and uncertainties over the ability of banks to increase their productivity and pass the price increases that will be necessary on to their customers.
- It is also difficult to anticipate the demands of the market in terms of both the ROE and the total level of capital required to access the best ratings that open up the best financing conditions.

1) Illustration of the procyclicity of prudential standards: economic slowdown => deterioration in the quality of risks => increase in prudential requirements => reduction in lending => increase in the economic slowdown.

Eurofi - Rue de Miromesnil 66, 75008 Paris - France / tel.: +33 (0)1 40 82 96 03 / fax: +33 (0)1 40 82 96 76 / www.eurofi.net

c. The impacts, which are difficult to assess, are significant, particularly in Europe

- The actual impacts of the reform on the volume and cost of credit are highly debated. However, it will have impacts: even if they are self-financed and their rise is spread over 7 to 8 years, the increase in prudential requirements will have a cost which will be covered either partially or entirely by the customer and worse, the increase could well give rise to a trend towards reducing credit (deleveraging).

- Such reforms will trigger realignments of financial activities which will not always be those which the public decision-makers were looking for. For instance, we may look at the recent development of forex transactions (+20%), notably due to "algorithmic trading" that is being widely debated in terms of its added value, at the very time when the US "Section 716" excludes activities on commodities and equity derivatives - but not on forex - from the activities covered by federal assistance.

- We can also raise the issue of the repositioning of institutions on the various customer segments depending on their respective ROE? Will this lead to a deterioration in the banks' service for their customers? More specifically, what will happen with offers for the least profitable customers? What will be the impact on European banking inclusion policies? Would the reforms not stimulate more lucrative but risky lending?

- The reforms are going to bring about a change in the dynamics for restructuring the financial sector, particularly in Europe. Their form and the benefits for the economy are difficult to anticipate. While the prudential reform penalises minority equity interests, what will be the basis for building the European partnerships that precede cross-border business combinations? Will all the bank statuses be able to comply with the new requirements?

- There is a risk of differences in terms of the implementation of the measures proposed by Basel to the G20 members, as they put some geographic areas at a greater risk of a credit crunch. Europe is particularly threatened given that banks finance 80% of its economy. Moreover, European banks store the credits in their balance sheets as they are deprived of the substantial support of Government Sponsored Entities (GSEs: Fannie Mae and Freddie Mac). Would not this accentuate deleveraging trends?

- Lastly, the notion that “Systemically Important Banks” are more dangerous and therefore require more capital is most questionable. Applying additional capital constraints and non risk-weighted leverage ratios on banks that specialised in wholesale and investment banking and are mainly funded in the wholesale markets may be understandable. But applying such rules to big banks whose activities are well diversified and whose funding is largely deposit-based is completely different. Large banks are not dangerous per se; all depends on their business-models. This should be taken into account in future regulations.

3. Strengthening supervision is also necessary

The new requirements on their own do not guarantee a genuinely sound system. The quantitative measures must be combined with improved supervision. Macroprudential supervision is seeing significant progress in Europe and in the rest of the world.

But for its part, microprudential supervision must be further strengthened in order for supervisors to be able to identify as early as possible the new risks resulting from financial innovation and the possible transformation of each financial institution's business portfolios. Such an approach makes it possible to avoid the application of systematic requirements set without proper foresight, particularly for cross-border institutions, which would accentuate a possible credit crunch.

4. Proposals

The potential cumulative impact of the various regulatory changes on economic growth has not been fully factored in to the regulatory reform. Several uncertainties are surrounding its implementation. Given the risks to financial stability inherent in a prolonged period of weak growth, detailed impact assessments should be updated and taken into account in the configuration and implementation of these reforms.

As a consequence, it appears to be essential to set up global and regional observatories in order to ensure appropriate monitoring of these reforms.

These observatories must:

a. Measure the consequences of prudential reforms on the volume and cost of credit, on the ability of the banks to find the capital required, as well as on the capacity of certain players to adjust, and the general consequences in terms of a level playing field and more broadly on the economy.

b. Identify the potentially adverse consequences of the reform (development of high yield and high risk products, excessive rise in prices, disappearance of certain offers with low levels of profitability notably accompanied by an increase in banking exclusion, deterioration in the banking service, etc).

c. Ensure consistency in the deployment of the reform.

d. Ensure that the new requirements are adapted in line with certain specific local features, without however allowing distortions of competition.

e. Proposing possible adjustments to the calibration and the architecture of Basel 3. In particular the actual leverage-ratio impacts should be closely examined; unless a segmentation of financial institutions according to their portfolio of activities is performed beforehand its current “one size fits all” definition is likely to mainly draw the attention of supervisors to the less risky banks that undertake traditional lending activities, possibly missing its objective to act as a backstop to risk based regulatory approaches.

Insofar as the prudential requirements on their own cannot guarantee the soundness of banks and the financial system, it is essential to further strengthen supervision. As mentioned by José Viñals (IMF staff position note may 2010), a good supervision must be “intrusive, sceptical, proactive, comprehensive, adaptive, and conclusive”. “This requires appropriate resources, authority, organization and constructive working relationships” between the different agencies involved. Above all this requires an effective “will” to act.
“Developing this “will to act” requires that supervisors have a clear and unambiguous mandate, operational independence coupled with accountability, skilled staff, and a relationship with industry that avoids “regulatory capture.”

More specifically, this stronger supervision must make it possible to identify any effective systemic weaknesses in financial institutions.

The European transposition of Basel 3 must be synchronised in the various regions around the world and factor in the impacts seen on lending highlighted by the observatories presented above.

Lastly, a review could also be carried out to facilitate the development of securitisation and alternative financing mechanisms, notably in favour of the most fragile customers (e.g. companies in particular) by facilitating access to the capital markets for European SMEs, by deploying guarantee and deposit mechanisms, etc..