Basel III Capital Requirements: Development Implications and Concerns

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Financial Crisis and the Right to Development

- The direct negative human rights impacts of financial and economic crises through loss of employment and livelihoods have been exacerbated by the subsequent policy responses of States.
- With tax payer-financed bailouts of private firms that followed the crisis causing inflated public debt, countries have been adopting fiscal austerity measures to deal with it.
- The reduced government expenditures on public investments and social support have lead to further severe negative impacts on rights, especially of the middle and low-income groups in society.
- => Increase not just in poverty, but socio, economic and cultural inequalities.

Post-crisis Banking Sector Regulation - Focus on Basel III

- Does post-crisis reforms in financial regulation help us put a break in the cycle of rights violations imposed by financial crises?
- One of the major thrusts of post-crisis efforts to strengthen financial regulation has been towards increasing the capital requirements imposed on banks to absorb unexpected losses.
- The Basel III norms introduced by the BCBS in November 2012 is scheduled for phase-in between January 2013 and 2019.
- Basel committee member countries have been required to translate the Basel III standards into national laws and regulations before January 2013.

The Logic of Basel Capital Requirements

- The idea behind capital requirement is to force banks to hold more of their own capital, because common equity or shareholders' equity is the last to be compensated in bank liquidation and therefore is always available to absorb unexpected losses without triggering bankruptcy of the bank.
- In order to dissuade banks from undertaking excessive risks, Basel framework bases the calculation of capital requirement on risk-weighted assets, which incorporates the riskiness of specified classes of borrowers.
- The focus under Basel I (1994), was on protecting banks against credit risk; and the minimum capital adequacy ratio (CAR) - the percentage of a bank's regulatory capital to its risk-weighted assets, was set at 8%.

Refinements in the Basel Framework

- The 1996 Market Risk Amendment introduced an explicit capital cushion for market risks due to banks' trading activities.
- The fully revised Basel II Framework that came into force in end-2006 proposed a more sophisticated and detailed structure than Basel I in several aspects.
- Three pillars: Pillar 1 contains the minimum capital requirements for operational risk apart from credit risk; Pillar 2 sets out the supervisory review process by national regulators; and Pillar 3 consists of the disclosure standards aimed at "market discipline".
- Pillar I involves greater sophistication in the types of risks and the range of asset classes included for calculating capital requirements, as well as the methods used for risk weighting - Standardised Approach (SA) and Internal Ratings-based Approaches (IRB).

Sophisticated Refinements Didn't Help

- Under the SA, credit ratings assigned to customers and countries are given centrality in the calculation of risk weights. This causes interest rates on loans to lower-rated and unrated borrowers to rise significantly.
- The advanced approaches (IRB) measure credit risk using sophisticated formulas, but these are based on inputs of risk parameters determined internally by banks.
- The greater use of banks' internal assessments of risk in the calculations for regulatory capital marked a clear shift to self-regulation by banks (especially among the bigger banks operating internationally).
- Most importantly, Basel II again focused only on the risk of individual banks, and did not take account of systemic risk in any way.
- Clearly, Basel II's "refinements" did not help => crisis.

Basel III – Objective to increase financial stability

- Basel II's weaknesses were exposed by the global financial crisis, namely that it:
  - underestimated the losses that regulatory capital should absorb (including counterparty credit risk);
  - overestimated the efficacy of Pillar 1 in containing leverage (borrowing for speculative investments);
  - forgot liquidity risk (banks being unable to convert their assets into cash easily at short notice);
  - did not consider the greater risk that systemically important financial institutions (SIFIs) pose to the stability of financial systems; and
  - did not pay enough attention to the fact that the design of capital requirements was such as to amplify the pro-cyclicality of credit and financial markets (Tonveronachi, 2011).

Basel III – Building Blocks (1)

- Basel III framework published in 2011 is supposed to address these shortcomings.
- Aims to raise the quantity, quality, consistency and transparency of the capital base
- Narrower definition of regulatory capital – with greater proportion of common equity.
- Aims to strengthen the risk coverage of the capital framework (particularly with respect to counterparty credit risk exposures arising from derivatives, repos and securities financing activities)
- Has led to a huge increase in the number of asset classes and risk weights, as well as increased capital charges for most kinds of exposures.

Basel III - Building Blocks (2)

- Introduces an additional Capital Conservation Buffer that can be drawn down in periods of increased stress;
- Also a Countercyclical Capital Buffer designed to address the concern that existing capital requirements are pro-cyclical;
- A new Leverage Ratio that aims to reduce the risk of a build-up of excessive leverage at the bank level;
- A new Liquidity Coverage Ratio meant to ensure that a bank has an adequate stock of high-quality liquid assets that can be easily converted into cash to meet its liquidity needs over a thirty-day period; and
- A Net Stable Funding Ratio meant to encourage banks to use stable sources to fund their activities (reference to a one year period).

Basel III - Increased Overall Capital Requirement on Banks

- Between 2013 and 2019 , the overall capital requirement will increase from 8% to 10.5% (adding the capital conservation buffer and the countercyclical capital buffer).
- Additional capital, ranging between 1- 3.5%, is to be maintained by globally systemically important financial institutions (G-SIFIs), depending on their level of systemic importance.
- Many components of the Basel III framework remain to be finalised by the BCBS.
- But national banking sector supervisors are ensuring that domestic laws for implementation of the revised capital requirements are put in place as soon as possible, purportedly, in order to protect their banking sectors against financial instability and contagion.

Basel III – Unequal Implementation Pressure on Developing Countries and Local Banks (1)

- Of the 27 BCSBS member countries, 11 jurisdictions now have final Basel III capital rules in force at the national level: China, India, Mexico, and South Africa, apart from Australia, Canada, Japan, Hong Kong SAR, Saudi Arabia, Singapore, and Switzerland.
- Three other developing country member jurisdictions – Argentina, Brazil and Russia – have also issued final national level rules, and will bring them into force by end 2013.
- BCBS insists that timely and consistent implementation of Basel III remains fundamental to "providing a level playing field for internationally active banks".
- But the US and nine EU members, home to most G-SIBs, are among the13 member countries that missed the 1 January 2013 deadline for issuing final regulations.

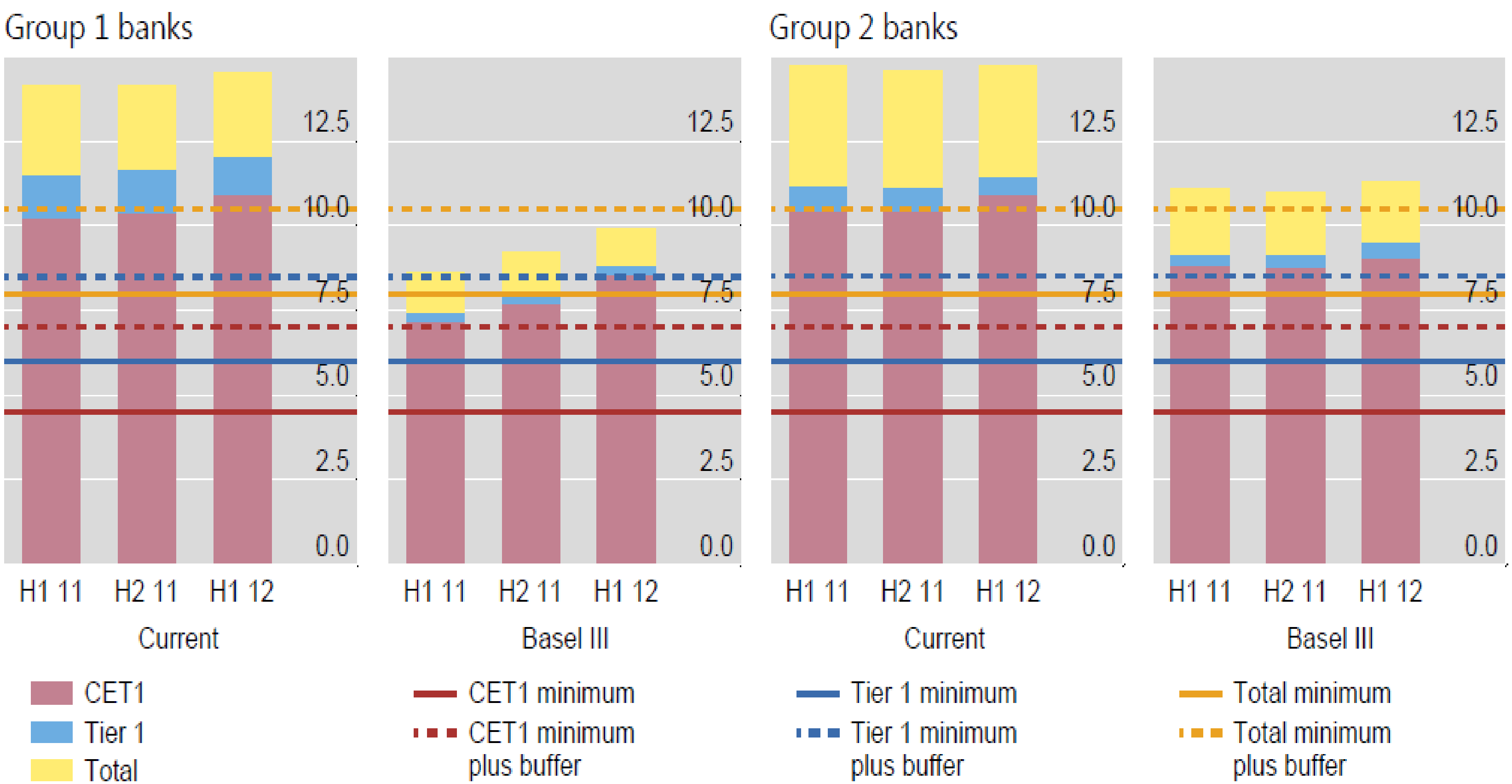
Basel III - Unequal Implementation Pressure on Developing Countries and Local Banks (2)

- The latter have only published their draft regulations. (The US is yet to fully implement Basel II).
- Meanwhile, as of end-June 2012, average capital ratios under the Basel III framework for a consistent sample of Group 1 banks (large internationally active banks) continued to remain lower than those for Group 2 (others) banks (See Chart, BCBS, 2013).
- There is pressure for compliance with Basel III norms in non-BCBS developing countries too, due to market pressure (especially in those with a significant degree of external financial liberalisation).
- Out of the 70 non-Basel committee member jurisdictions surveyed by the Financial Stability Institute, more than half were in the process of implementing Basel III.

Basel III - Differential Implementation Pressures on Developing Countries (3)

Average CET1, Tier 1 and total capital ratios

Consistent sample of banks, in per cent Graph 2



Continuing Weaknesses in Basel III (1)

But even as it attempts to address some of the serious deficiencies of Basel II, Basel III retains fundamental problems in the framework.

- The complex risk assessment methodology continues to rely on ratings generated by banks' internal models for the estimation of exposure to risk.
- But banks' exposures to other banks and other financial institutions are often associated with non-transparent transactions whose potential risk is difficult to assess.
- As found under Basel II, under internal models, banks will be able to assign favourable risk weights on riskier transactions through innovative financial instruments and accounting practices in order to reduce the average risk weight of a class of assets (Kregel, 2011, Cornford 20.12, etc.)

Continuing Weaknesses in Basel III (2)

- The Basel Committee has been carrying out assessments of the consistency of national regulations with the requirements of the Basel framework (RCAPs).
- A January 2013 assessment analysed the sources of variation across banks in their estimates of risk-weighted assets (RWAs).
- BCBS admits that the considerable variation in the risk weighting of assets reflect to a considerable extent “elements of the flexibility provided to banks and supervisors within the Basel framework” (BCBS 2013).
- Clearly, the underlying framework remains faulty and continues to give scope for banks to tweak their internal models for complying with capital requirements.

Continuing Weaknesses in Basel III (3) - Does not take care of fundamental problems

- As long as multi-functional banking remains, the incentive to take on additional risks to make extra profits through financial engineering will remain.
- Therefore, first of all, just as how the refinement achieved in Basel II (over Basel I) in risk categorisation did not prevent the global financial crisis, Basel III will prove inadequate in foreseeing newer financial innovations that increase financial fragility.
- Secondly, there is continued reliance on "market discipline", which is misplaced: Given that SIFIs cannot be allowed to fail, the associated moral hazard means that there is no effective "market discipline".
- => Systemic stability continues to be elusive under Basel's risk-based capital framework.

Capital adequacy requirements are not adequate as a crisis prevention measure

- Thus there is no guarantee that the higher, or more refined capital requirements imposed by Basel III will prevent another financial crisis.
- The higher capital requirements under Basel III are thus not sufficient to put a break to the '*cycle of rights violations*' imposed on developing countries owing to the fact that they do not reduce the inherent increased fragility consequent upon financial liberalisation and multi-functional banking.

Higher capital requirements also threaten to undermine financial inclusion

- At the same time, the significant increase in regulatory capital and implementation costs for banks under Basel III are expected both to decrease credit availability and increase cost of credit.
- This will have disproportionately negative impacts on SMEs, traditional businesses, as well as women and other vulnerable groups in society with lack of access to assets.
- Most or all of these are in the informal sector, which constitutes the majority of employment in many developing countries.
- Thus the higher capital requirements will have an adverse impact on the progressive achievement of economic, social and cultural rights also by reducing the banking sector's ability to support work and livelihoods of the middle- and lower-income groups.

Further Implications of National Implementation (1): An example

- Indian Banks are currently operating on the Standardised Approaches of Basel II. But the larger banks had to migrate to the Advanced Approaches, especially as they expanded their overseas presence.
- Even as it finds itself unable to resist pressures for further financial liberalisation, and given the failure of Basel II to prevent the global financial crisis, the RBI considers it "prudent" to maintain one percentage higher CAR than the Basel III prescribed norm.
- Under Basel III, Indian banks need an additional capital requirement of roughly USD 82 billion by March 2018, of which equity capital will be about USD 30 billion.
- Over the last five years, equity capital raised by banks through the primary markets amounted to only about USD 9 billion.

Further Implications of National Implementation (2)

- Even assuming similar market demand, much of the recapitalisation burden of public sector banks (PSBs) to meet the capital requirements would fall on government budget during 2013-19 (about USD 15 billion at current levels of government shareholding).
- ➢ Further squeeze on public investments and social spending.
- With continuous market pressures for sticking to "fiscal targets", the other option for the government is to go for the privatisation route.
- ➢ This will have further adverse implications on RTD through reduced access to credit for informal and marginalised sections, as experience with private banking has shown.

The Way Forward - more fundamentally

1. First, systemic change in financial sector operations through the structural separation of commercial banking and investment banking.
   - ➢ This precludes the potential for innovative financial engineering from leading to pyramiding of risks and increase in systemic risks, which lead up to financial crises and affect sustained economic growth, development financing and social spending.
2. Secondly, limit the scope for entry of foreign financial service providers into developing countries (including through trade and investment treaties).
   - ➢ As crisis after crisis has shown, entry of foreign financial service providers into developing countries under liberalised financial markets and open capital accounts increases financial fragility and magnifies the problem of contagion of financial instability that trade in financial services generate elsewhere.

- THANK YOU!