BASEL III

1.0. <u>Basel Committee on Banking Supervision (BCBS)</u>

Following the failure of German Herstatt Bank in the early 1970's, the Basel Committee on Banking Supervision (BCBS) was created as a Committee of banking supervisory authorities of the G-10 countries[1], whose objectives are to strengthen banking supervision and stability of financial institutions, mainly banks. It has been developing standards and rules to this end since 1988.

<u>Basel I</u> is the first of the Basel Accords, which are recommendations on banking laws and regulations issued by the BCBS. Basel I was issued in 1988 and sets out the minimum capital requirements of financial institutions with the goal of minimising credit risk. Banks that operate internationally are required to maintain a minimum amount of 8% of their capital base (Tier 1 and Tier 2) on a percentage of the risk-weighted assets. Since 1988, this framework has been progressively introduced in a number of countries.

<u>Basel II</u> is the second of the Basel Accords introduced in 2001. It is an effort by the international banking supervisors to update the original international bank Capital Accord (Basel I). The revised Accord aims to improve the consistency of capital regulations internationally, make regulatory capital more risk sensitive and promote enhanced risk-management practices among large, internationally active banking organisations.

The new framework is more sensitive to the risks that banks face by incorporating an explicit measure for operational risk and includes more risk sensitive weightings against credit risk. It reflects improvements in banks' risk management practices, for example, the Internal Ratings Based Approach (IRB) that allows banks to rely to a certain extent on their own estimates of credit risk. It also provides incentives for banks to improve their risk management practices, with more risk sensitive weights, as banks adopt more sophisticated approaches to risk management. The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations such as the minimum capital requirements that banks need to put aside to guard against the types of financial and operational risks they face in their daily business.

Advocates of Basel II believe that such an international standard can help protect the international financial system from the type of risks that might arise should a major bank or a series of banks collapse.

Basel II is comprised of three pillars as follows:

- The **first pillar** deals with the *minimum capital requirements* and basically describes the capital requirements for *credit risk, market risk* and *operational risk.*
- The **second pillar** deals with the *supervisory approach*, whose aim is to encourage banks to develop better methods to measure and manage the various risks.
- The **third pillar** deals with the *disclosure requirements* and recommendations for banks.

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[1] The G10 countries are: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States of America

Basel III

Following the 2007-2009 financial crisis emanating from the US, Basel II was criticised on many fronts, notably, improper definition of capital, lack of liquidity management and it ignores procyclical effect. Basel III was thus proposed as a standard regulation for the global banking system as a response to the recent crisis.

2.0. Salient features of Basel III as per BCBS

Basel III is divided into three pillars on the basis of the main areas they address: Pillar I is on capital reforms, risk coverage and leverage; Pillar II embraces risk management and supervision and Pillar III is on market discipline. It also includes new liquidity standards and a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (G-SIBs).

2.1. Pillar 1

2.1.1. Capital Reforms

Total regulatory capital shall consist of the sum of Tier 1 Capital and Tier 2 Capital. Tier 1 Capital comprises of Common Equity Tier 1 (CET1), which is a new core Tier 1 ratio introduced and Additional Tier 1 Capital.

Quality and level of capital - There will be more focus on common equity. The minimum capital will be increased to 4.5% of risk- weighted assets, after deductions.

Capital loss absorption at the point of non-viability
Contractual terms of capital instruments embraces a clause that permits – at the discretion of the regulator – write-off or conversion to common shares in the event the bank is seen to be non-viable. Capital loss absorption amplifies private sector contribution in helping to deal with future crises and helps to reduce moral hazard.

Capital Buffers
2 types of Capital buffers are introduced namely, the Capital Conservation Buffer and the Countercyclical Capital Buffer, designed to be used in times of stress and to protect banking systems against risks involved with excess credit growth.

A *Capital Conservation Buffer* comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range. A *Countercyclical Capital Buffer* will be imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.

2.1.2. Risk Coverage

Securitisations **-** Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures.

***Trading book* -** Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the Trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account.

***Counterparty credit risk* -** Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures.

***Bank exposures to Central Counterparties (CCPs)* -** The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.

2.1.3. Leverage Ratio

A simple non risk based leverage ratio will be introduced, which is intended to constrain build up of excessive leverage in the financial system. The basis of calculation is the average of the monthly leverage ratio over the quarter based on the definitions of capital (the capital measure) in Basel III and the total exposure (the exposure measure).

2.2. Pillar II: Risk management and supervision

The Pillar II addresses firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.

2.3. Pillar III: Revised Disclosure Requirements

The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.

2.4. Liquidity Reforms of Basel III

Liquidity Coverage Ratio (LCR)

The LCR will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors.

Net Stable Funding Ratio (NSFR)

The NSFR is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.

Principles for Sound Liquidity Risk Management and Supervision
The Committee's 2008 Guidance Principles for Sound Liquidity Risk Management and Supervision takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations.

Supervisory Monitoring
The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.

2.5. Systemically Important Financial Institutions

In addition to meeting the Basel III requirements, global systemically important financial institutions[2] (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.

The phase-in arrangements regarding Basel III implementation is appended below:

Table 1: Basel III phase-in arrangements (All dates are as of 1 January)

	Phases	2013	2014	2015	2016	2017	2018	2019
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1	
Capital	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				4.5%
Capital	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
Capital	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Capital	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%
Capital	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%
Capital	Minimum Total Capital		8.0%					8.0%
Capital	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	10.5%
Capital	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013					
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	100%
Liquidity	Net stable funding ratio						Introduce minimum standard	

Source: Bank for International Settlements (BIS) – 2013

[2] A systemically important financial institution (SIFI) is bank or any financial institution whose failure may trigger a financial crisis. The Basel Committee has identified factors for assessing whether a financial institution is systemically important: its size, its complexity, its interconnectedness, the lack of readily available substitutes for the financial infrastructure it provides, and its global (cross-jurisdictional) activity. In some cases, the assessments of experts, independent of the indicators, will be able to move an institution into the SIFI category or remove it from SIFI status.

3.0. The Mauritian route from Basel I to Basel III

Following the **Basel Capital Accord I** that was adopted in 1988, the Bank of Mauritius (BoM) issued some guidelines and the capital requirements of 8% was effective in November 1993. However, the flat 8% was deemed not to sufficiently differentiate underlying risks. In January 1997, BoM thus raised the ratio to 9% and further to 10% in July 1997 as banks were required to increase their paid-up/assigned capital.

Basel II became operational in Mauritius as from end March 2008 on a one-year parallel run with Basel I and was fully implemented as from end of March 2009. Banks had to apply, during this transitory period, both the Guidance Notes on Risk Weighted Capital Adequacy Ratio (Basel I) and the Guidelines issued by the Central Bank in the context of the Basel II implementation for the computation of their Capital Adequacy Ratio at 10% while Basel II left the overall minimum capital requirements at 8% globally.

Basel III has been implemented by 11 Basel Committee member jurisdictions[3] but not in Mauritius. BoM has issued a Consultation Paper in October 2012. The gist of the paper is to set out the Basel III rules and BoM's proposals for implementation of the core Basel prescriptions as well as the timelines. The paper is expected to offer a backdrop for banks in Mauritius to build up their own strategies to comply with the Basel III requirements. BoM has also proposed to adopt new guidelines and revise existing guidelines to align them with the Basel III rules.

FURTHER READING

1. Bank of Mauritus, Annual Reports, Various Issues.
2. Bank for International Settlements (2010), Basel III: *'A global regulatory framework for more resilient banks and banking systems'*, Basel Committee on Banking Supervision, ISBN 92-9131-859-0.
3. Bank of Mauritius, Financial Stability Reports, Various Issues.
4. Bank for International Settlements (2011), *'Treatment of Trade Finance uncer Basel Capital Framework'*, Basel Committee on Banking Supervision, ISBN 92-9131-890-6.

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[3] Australia, Canada, China, Hong Kong SAR, India, Japan, Mexico, Saudi Arabia, Singapore, South Africa and Switzerland