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THE STATE OF BASEL III

Although regulators are turning the heat up on compliance with Basel III, ASEAN banks are staying ahead of the regulatory curve.

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THE STATE OF BASEL III

ALTHOUGH REGULATORS ARE TURNING THE HEAT UP ON COMPLIANCE WITH BASEL III, **ASEAN BANKS ARE STAYING AHEAD OF THE REGULATORY CURVE.** BUT ONLY TIME WILL TELL IF THESE STRINGENT EFFORTS ARE ENOUGH TO AVERT THE NEXT FINANCIAL CRISIS.

In yet another overhaul of regulations, Basel III marks the most concerted global effort by regulators, lawmakers and financial players to reduce systemic risk in their bid to avert a repeat of 2008's financial crisis.

Although the timeline for full compliance is by 2019, the majority of jurisdictions are currently well into the implementation phase, with the Basel Committee on Banking Supervision (BCBS) coordinating member states at the global level and monitoring non-member states at regular intervals.

REPORT CARD

Most countries issued regulatory guidelines for banks by end-2013. Across the board, although the pace of reform varies there is a trend of early compliance especially in capital adequacy requirements, with more tempered success in leverage and liquidity measures.

Data and progress reports by BCBS support a number of key conclusions:

- **Capital adequacy requirements have been largely met ahead of schedule.** Previous concerns have melted away as banks exhibit eagerness to shore up capital. Across the board, there is early compliance ahead of 2019's fully phased-in minimum capital requirements of 4.5% CET1 (Common Equity Tier 1) as well as the total common equity standard of 7% (comprising common equity of 2.5% RWA [risk weighted assets]). According to BCBS' November 2015 report on Implementation of Basel Standards, there was zero capital shortfall in all Basel member states' internationally active banks. However, the downside of raising the capital adequacy bar is reduced supply of available credit which in turn raises the cost of lending. This concern continues to niggle the market, with ever-watchful eyes on return on equity and investment.

- **Room for improvement on banks meeting the leverage ratio.** Designed as a supplementary measure to Basel II, the requirement for banks to hold capital equal

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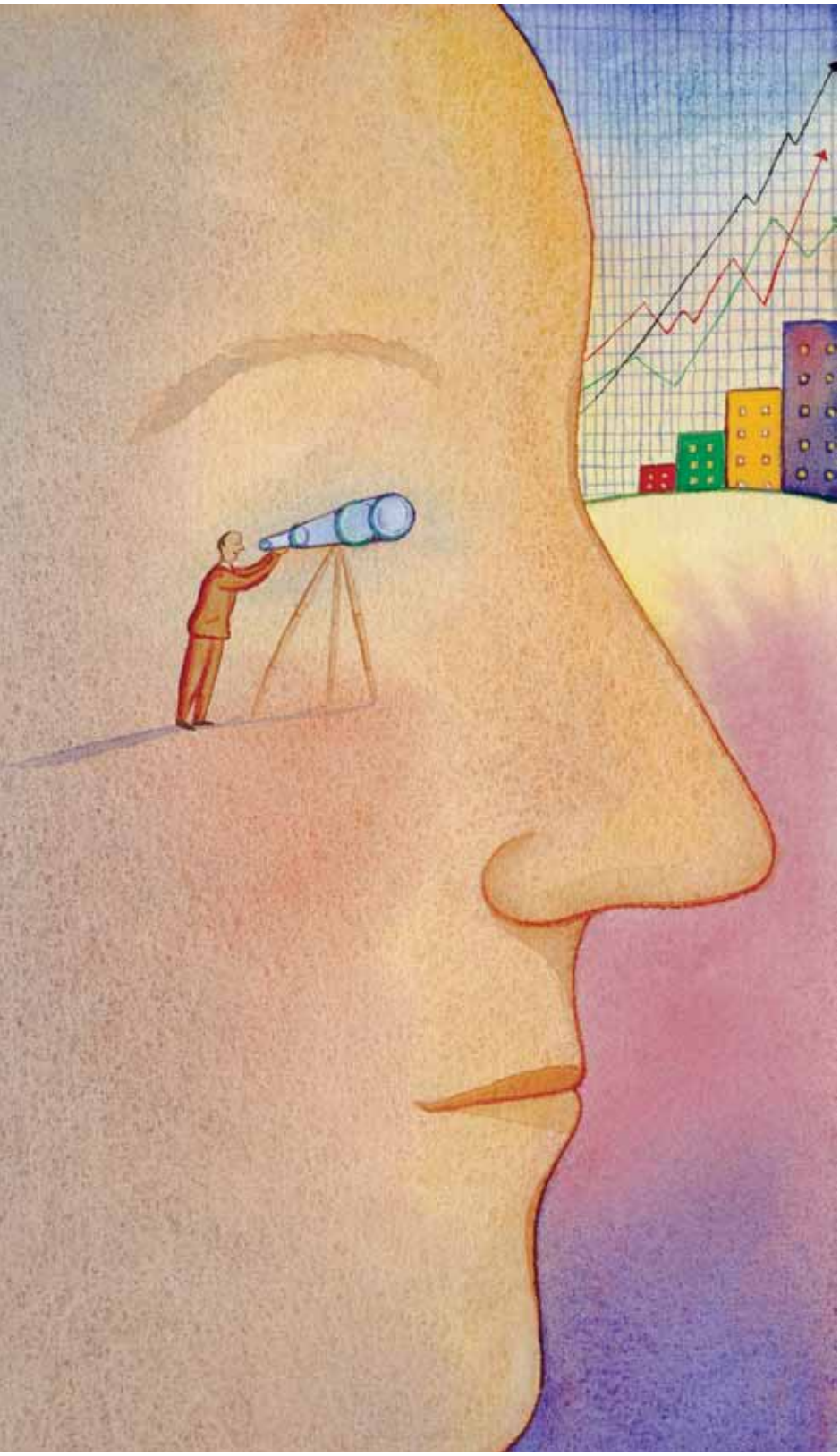

to 3% of assets was mooted to cool excessive lending. Some countries such as the UK have proposed that the percentage be increased during boom times. BCBS recently simulated scenarios to assess the preparedness of member states to meet the leverage ratio based on the fully phased-in Basel III Tier 1 leverage ratio. Out of 221 banks, 10 banks didn't make the cut with an aggregate shortfall of 3.7 billion. Furthermore, three out of these 10 banks fell short of meeting the Tier 1 target capital ratio of 8.5%.

- **Capital buffers have finally been set and if banks fall within the buffer range, constraints will be imposed on distributions of capital without affecting operations.** These buffers seek to mitigate stress in the market and banks are required to hold:
  - A capital conservation buffer - set at a minimum 2.5% of RWA.
  - A countercyclical buffer - calibrated between 0%-2.5% of RWA as recommended by BCBS.

  The countercyclical buffer will ultimately be determined by domestic regulators who will monitor credit growth and establish triggers to spot build-up of excessive system-wide risks. Already, EU members such as Sweden have set higher than required countercyclical buffers at 1.5% effective 1 January 2016 although the adoption has been much less rigorous in Asia.

- **In a bid to end "Too Big To Fail", the Financial Stability Board (FSB) issued its final systemic buffer applicable to global systematically important banks.** A total loss absorbing capacity (TLAC) of at least 16% of group's RWA is required starting from 1 January 2019 and 18% by 1 January 2022. The FSB-led impact assessment estimated that the benefits of TLAC such as reduced probability and cost of crises (15-20 bps) outstripped costs such as increased borrower's rates (2.2-3.3 bps) and annual output costs (2.0-2.8 bps of GDP).

- **Compliance to liquidity ratios continues its uptrend.** This indicates sufficient high quality liquid assets to withstand market shocks and decreased reliance on short-term wholesale funding and in effect greater funding stability. BCBS reported that weighted averages for both the liquidity coverage ratio (LCR) and net stable funding ratio were above

Beyond the Bare Minimum

SOCIETE GENERALE IS MAKING THE MOST OF ITS MOVE TO ASSESS COUNTERPARTY RISK AHEAD OF BASEL III.

Going beyond bare minimum compliance, Societe Generale has implemented an enterprise-wide IT solution that automates the calculation of credit valuation adjustment (CVA) and other risk variables to churn millions of financial simulations which would directly feed into traders' desktops. The result: At the press of a button, they now have access to crucial real-time information on counterparty credit risk, alternative trades of varying risks or better yields.

BIG WINS

- Streamlined approach to valuing CVA.
- Efficient capital allocations as traders actively manage their positions – identifying lower-risk trades, and proactively offer better pricing to lower-risk counterparties.
- Foreseeable reduction of bank's risk profile.

DRAWBACKS

- Operational overhaul and cost of integrating solutions to back-, middle-, front-office and bank-wide processes.

Have the benefits of this enterprise-wide implementation justified its cost? Keyvan Silvain, Head of the CVA Desk in Paris, says: "… we have made a very good return on our investment. The capital optimisation is very significant, and we have reduced our capital for VaR (Value at Risk) and CVA considerably with our hedging positions."

the 100% mark. Although there are laggards, these are gradually decreasing in number and size. A key finding from the European Banking Authority's impact assessment found that the new liquidity standards did not reduce lending to the real economy (SMEs, trade finance) or adversely affect financial markets, putting to rest fears that LCR would hamper economic growth.

- **Post-crisis, some countries have used early compliance as a strategic tool to mitigate reputational risk and restore trust.** Setting ambitious targets above and beyond the minimum requirement has had a two-pronged effect:
  1. It signals to the market that fundamentals are sound and above industry average;
  2. This raises their standing in the eyes of peers and regulators.

  A case in point is the Monetary Authority of Singapore (MAS) which is ahead of the curve by transposing Basel III to island-incorporated merchant banks and instructing non-bank financial institutions to adopt the risk-based capital framework, ahead of many other Basel peers.

- **Strengthening risk capture is still a work-in-progress.** This is one of the more progressive Basel III features which casts a wider net to cover a spectrum of other critical risks in the trading book, securitisation and counterparty credit assessment. The implementation is less straightforward than other capital adequacy initiatives as the proposed framework imposes a significant operational burden and opens up gray areas which are still in the process of refinement via consultations between BCBS, regulators and banks. For instance, there are now stricter boundaries on what instruments can or cannot be switched between trading book and banking book to curb potential arbitrage but the downside is that operationalising the framework will be complex and eat into banks' bottom lines. Market players have reverted with simpler and less costly alternatives that would sufficiently capture risk over various asset classes and liquidity horizons.

- **Increased regulations have put pressure on margins, leading to banks redesigning their portfolio.** To illustrate,

The region is ahead of the curve in a number of aspects. According to Moody's Investors Service, the majority of ASEAN banks are well-capitalised, on target to meet capital adequacy requirements and are expected to maintain higher quantity and quality of capital compared to its international peers.

PricewaterhouseCoopers' 2015 'Indonesian Banking Survey' found that while banks in the archipelago acknowledged the need for capturing credit, liquidity and operational risks in the system, margin pressures remained a top concern. Local, *Shariah* and state-owned Indonesian banks have met this challenge by switching their portfolios to focus on more broad-based fee income like insurance, remittances, and higher-yield products such as SME loans.

- **Interpretations differ between jurisdictions, leading to inconsistency and lack of comparability.** This applies to a wide range of Basel III rules from quantitative models and definitions to more qualitative aspects such as assessment frameworks and reporting. For instance, there is no global minimum standard for a countercyclical capital buffer assessment framework, and Hong Kong regulators allow banks to report biannual rather than quarterly figures. Basel member states and regional groupings such as the EU and ASEAN are currently working to streamline material inconsistencies.

ASEAN TRENDS

The region is ahead of the curve in a number of aspects. According to Moody's Investors Service, the majority of ASEAN banks are well-capitalised, on target to meet capital adequacy requirements and are expected to maintain higher quantity and quality of capital compared to its international peers. For instance, Malaysia and Singapore voluntarily apply more stringent definitions of CET1 where unrealised gains are not fully accounted for. Philippines has also applied an above-average leverage ratio of 5% and banks should comply by 1 January 2017, a full year ahead of the recommended Basel deadline. By 2019, CET1 will be raised from 4.5% to 6.5% with Singapore and Philippines at the higher end, and Malaysia, Indonesia, and Thailand at the lower end of the compliance spectrum.

ASEAN has also seen an increase in issuance of Basel III-compliant debt papers in order to build up their balance sheet and enhance liquidity positions. Moody's reported improved uptake of debt papers despite investors taking on losses if the point of non-viability rate or other triggers kick in. To gauge sentiments, in 2014, Krung Thai Bank issued Thailand's first-ever Basel III instrument – a USD700 million 10-and-a-half-year bond – three weeks after a coup by the nation's army. The issuance retains its position as the highest yielding Thai-denominated bond.

One notable drawback is that despite meeting minimum requirement targets, comparability of performance and ratios amongst ASEAN countries is difficult. Indeed, harmonisation of regulations across different jurisdictions is a daunting task but necessary in order to mitigate the risk of arbitrage. This challenge

+ harmonisation of regulations across different jurisdictions is a daunting task but necessary in order to mitigate the risk of arbitrage. This challenge requires more than just the will to change.

Aside from crucial technical and operational aspects which need to be ironed out, banks must find their balance between growth and curbing risky behaviour. There is no mother-of-all-solutions; we have seen swathes of change from Basel's infancy to its latest form as regulators seek to impose financial stability.

requires more than just the will to change. In economies such as the New ASEAN-5 – Brunei, Cambodia, Laos, Myanmar, Vietnam – development is a strong motivator but it has multiple structural advancements to make before it catches up with others.

Case in point: Myanmar. Banks have yet to implement Basel I but the recent lifting of international sanctions has added incentive to overhaul its outmoded financial system. With a 53 million population, financial reforms include debates on granting independence to the Central Bank of Myanmar and enhancements to its recently-passed Banks and Financial Institutions Law (pending the Presidential signature), which as far as possible will bring it in line with Basel III. Already, smaller banks are jittery. But like how the ADB predicts Myanmar could be one of Asia's fast-growing economies expanding at 7%-8% per annum, it would not be too far a stretch to say that successful regional economic integration may just be ASEAN's crowning glory.

Casting the net wider, early day forecasts of an East-West disparity in Basel III's approach are gaining traction. Many in the East view the accord as a 'one size fits all' solution that fails to address the distinctive risks of its emerging economies. As a result, calls are emerging for an 'Asian voice' in the international reform of finance. At an October 2015 Borrowers & Investors Forum, Standard & Poor's Head of Financial Institutions Ratings, Ritesh Maheshwari succinctly expressed this sentiment: "The key agenda for Asia Pacific banks is to manage credit growth, rather than cushion against losses." The range of issues raised include bail-in features, simpler risk-weighted assets rules to bring down the region's cost of capital, and implementation of TLAC.

'JACK BE NIMBLE'

While regulators are trying their best to rein in risk, doomsday prophecies continuously abound. *Bloomberg's* report on 28 March 2016 titled 'The Next Perfect Storm' opened with these ominous words: "Those looking for when the next financial crisis might be should set a reminder for 1 January 2018."

What this means is that the effectiveness of Basel III will only be known when the next wave hits our shores. Aside from crucial technical and operational aspects which need to be ironed out, banks must find their balance between growth and curbing risky behaviour. There is no mother-of-all-solutions; we have seen swathes of change from Basel's infancy to its latest form as regulators seek to impose financial stability. Banking will continue its evolutionary path and the future prosperity of individual players will depend very much on how well and quickly the sector adapts to change.

GET READY FOR 'BASEL IV'

LOOMING ON THE HORIZON IS **A NEW SET OF REQUIREMENTS UNOFFICIALLY DUBBED 'BASEL IV'.** YOU WILL, HOWEVER, BE HARD PRESSED TO FIND AN OFFICIAL REFERENCE TO BASEL IV FROM THE BASEL COMMITTEE AS THE PROPOSED CHANGES ARE MORE LIKE A DISPARATE SET OF AMENDMENTS COVERING PREVIOUS ACCORDS RATHER THAN A NEW STANDARD FOR BANKING.

Nomenclature aside, the objective of Basel IV is to enhance the comparability of risks across all banks in different jurisdictions. It does so by incentivising financial institutions to adopt a newer version of the Standardised Approach (SA), currently used and easily adopted by smaller banks, over the alternative Internal Model (IM) approach.

Big banks in general opt to employ the IM approach to capture more granular risks. The IM approach leads to more sophisticated risk modelling and could lead to lower RWAs, the primary advantage for banks adopting IM over SA.

Basel IV seeks to turn the tides. The Revised SA is expected to strengthen and reflect greater sensitivity for a comprehensive range of risk elements – credit, counterparty, securitisation, market, operational, CVA, and step-in – and achieve harmonisation of reporting and regulations across jurisdictions.

By 'beefing up' existing standardised models, the objectives of Basel IV are summarised as:

- **Balancing risk sensitivity vs. complexity.** Recent studies on Basel have shown that depending on the risk model employed, banks with portfolios bearing similar levels of risk showed an excessive level of variability in calculated RWA. The IM approach allows for greater risk precision but its most glaring drawback is that it hampers overall market discipline – there is no baseline for comparison with hundreds of different IMs being used throughout the industry. The move towards adopting the Revised SA aims to achieve the robustness of Basel II and III yet reflect the simplicity of Basel I, enabling both international and local banks to be assessed on the same fundamentals.

- **Emphasis on feasibility.** To enhance reporting comparability, the Revised SA will introduce new dynamic drivers based on availability, intuitiveness and ability to correlate/explain trends across jurisdictions. For instance, it reintroduces external ratings as a component of credit risk albeit in a non-mechanistic way i.e. external ratings will no longer be central to RWA calculations and will instead be used for more general economic assessments such as customer selection and pricing. This about turn after BCBS' proposed ban on use of external ratings has been lauded by the British Bankers'

These proposed changes, comprising RWA calculations and Pillar III disclosures, are not expected to affect Capital-to-RWA ratios but will significantly increase capital requirements. Several revisions have been proposed by BCBS while other revisions are still in the consultation phase, and already, fail-safe mechanisms have been introduced in this new standardised approach.

Association as "a step in the right direction on credit risk".

- **Limiting national discretion.** Jurisdictions will experience a rollback on national discretions in order to harmonise reporting and regulatory standards including capital requirements. A more punitive approach is also expected in the form of higher risk-weights imposed on non-compliant banks for omissions such as missing information on counterparties and other risks.

- **Introducing obligatory capital floors.** In order to bridge the disparity between Revised SA and IM, floors are likely to be imposed on both approaches. For example, Revised SA may impose that the Probability at Default (PD), a key output of the IM approach, cannot fall below a specific threshold, say 10%. This means that under the IM approach, even if a portfolio has a PD of 4%, it must use the 10% minimum imposed under the Revised SA when calculating RWA, to enable comparability of output derived under both approaches.

These proposed changes, comprising RWA calculations and Pillar III disclosures, are not expected to affect Capital-to-RWA ratios but will significantly increase capital requirements. Several revisions have been proposed by BCBS while other revisions are still in the consultation phase, and already, fail-safe mechanisms have been introduced in this new standardised approach. Example: although external credit ratings are allowed for general assessment, banks will be required to conduct their own due diligence to assess if capital requirements should be higher.

Discussion are just beginning on the widely touted Basel IV but already, diverse views are emerging.

Bundesbank's Andreas Dombret, the board member overseeing bank supervision, expressed support for simplified rules which would aid smaller banks on calculating market risks but emphasised, "We are working on the finalisation of Basel III, and on nothing else." On the end of the spectrum, *Euromoney* recently characterised Basel IV as yet another series of 'blunt standardised measures'.

Irrespective, the industry should brace itself for another round of reforms post-Basel III. ✱

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