ТЕНДЕНЦИИ И ПРЕДИЗВИКАТЕЛСТВА В РАЗВИТИЕТО НА ИКОНОМИКАТА

Сборник с доклади от международна научна конференция

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Икономически университет - Варна

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**„ТЕНДЕНЦИИ И ПРЕДИЗВИКАТЕЛСТВА
В РАЗВИТИЕТО НА ИКОНОМИКАТА”**

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CAN BASEL III PREVENT FUTURE FINANCIAL CRISIS?

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Abstract

The financial sector is crucial for the smooth functioning of the economy. For this reason, the authorities use financial regulation as a means to ensure the stability of the banking system and to correct those 'market failures' that would otherwise threaten the solidity of financial institutions.

Recently introduced Basel III on the new bank capital and liquidity standards, (that is going to be implemented gradually starting from 2013 till 2019) is changing the way that banks address the management of risk and finance. The new regime seeks much greater integration of the finance and risk management functions.

In general , the regulations on capital requirements represent a major step forward in strengthening financial sector stability.

However the implementation of Basel III might be followed with certain risks, which might have negative impact on financial stability and progress of the economy.

The paper highlights the positive but as well as the negative implications of BASEL III requirements that need to be addressed and analyzed before its practical implementation.

The paper refers mostly to the to restrict access to credit, by creating tighter credit conditions for small and medium-sized firms, and for start-up businesses which will directly affect SME development .

The tightened criteria for BASEL III might have certain negative impact on economic growth in the medium to long term period. It is also important to mentioned that so called "Shadow banking (such as insurance firms, hedge and pension funds, and investment banks) played a central role in the latest financial crisis and has become a major provider of credit.

However, the Basel Committee's proposals do not concern this increasingly important sector of the financial system; this means that Basel III affords shadow banking a competitive advantage and is likely to incentivize risk taking in this sector. Moreover, in the event of an insolvency crisis in the non-bank financial sector, the banking system will be unlikely to remain immune to

the risk of contagion.

The global financial and economic crisis has provided an opportunity for fundamental restructuring of the approach related to risk and regulation in the financial sector.

Recently introduced Basel III on the new bank capital and liquidity standards**,** (that is going to be implemented gradually starting from 2013 till 2019) is changing the way that banks address the management of risk and finance. The new regime seeks much greater integration of the finance and risk management functions by raising capital requirements for banks and strengthening the stability of the global financial system.

According to the suggested new rules[55]:

• The definition of capital will be narrowed to common shares and retained earnings -the Tier 1 capital requirement ratio will increase from 4.0% to 6.0%.

• The required ratio of equity to risk-weighted assets will rise from 2.0% to 4.5%. Under Basel III, equity over risk-weighted assets will be considered as the benchmark ratio, replacing the Tier 1 capital ratio.

• The new rules will introduce a 'capital conservation' buffer that will have to be above 2.5% and be met with common equity; in periods of stress (when the banks' capital ratio falls below 7.0%), financial institutions will be authorised to draw upon this capital buffer by curtailing the distribution of dividends or bonuses. These measures are supposed to address the problem whereby, under Basel II, capital requirements were inadequate to withstand significant losses.

• The Basel Committee also proposes to set up a counter-cyclical capital buffer of between 0% and 2.5%,to be in effect only in periods of excessive credit growth (based on the national regulators' discretion).

The goal of this rule is to correct the pro-cyclicality of Basel II, particularly in periods of economic expansion. In addition, the proposed regulations aim to strengthen this system by introducing a leverage ratio of 3.0%: in any case, the ratio of capital to total assets will have to be above this threshold.

As per **financial stability** the BASEL III introduces two new

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[55] Pierre-Etienne Chabanel – "Implementing Basel III " pg. 12

liquidity standards as follows[56]:

The Liquidity Coverage Ratio ("LCR"): intended to measure a bank's ability to access funding for a 30 day period of acute market stress. Banks will be required to have a segregated stock of highly liquid and unencumbered assets that are at least equal to its estimated "net cash outflows" for a thirty day period during a time of acute liquidity stress.

The Net Stable Funding Ratio ("NSFR"): with a purpose to limit short-term liquidity mismatches and encourages the use of longer term funding. A bank is required to have stable funding sources in excess of the amount of stable funding it would likely need over a one-year period of extended market stress. This is a longer term structural ratio that covers a bank's entire balance sheet as well as certain off-balance sheet commitments.

Despite the fact that Basel III provides for long implementation periods for these ratios, banks will need to be in a position to report data regarding liquidity by the beginning of the relevant observation period (which is January 1, 2012 for both the LCR and the NSFR). Banks may also be subject to market pressure to comply with the liquidity ratios even before the deadlines set out in Basel III.

In general, an effective implementation of Basel III is intended to demonstrate to regulators, customers, and shareholders that the bank is recovering well from the global banking crisis of 2008. A speedy implementation in the period of 2013-2019 year , suppose to contribute to a bank's competitiveness by delivering better management insight into the business, allowing it to take advantage of future opportunities. It is no doubt that the overall new design for capital and liquidity requirements is well-intended, and might be more prudent than previous ones within the international banking standards. However, it seems that the Basel III Accord misses the main lesson of the global financial crisis: Over reliance on regulatory structures decreases incentives for financial institutions to be more aware about the risk taking and self-provision of liquidity and financial stability.

Most of the analysts of the recent global crisis agree on the fact that

[56] A D&B Special Report "The Business Impact of 'Basel III', , pg 7

the old BASEL II requirements and rules practically increased the risk in the system, instructing the banks to increase the less-risky assets, which make them eager to pack up toxic mortgage loans into securities which required significantly lower capital to be held in reserve than the toxic loans required.

What brought banks to their knees wasn't direct exposure to sub-prime loans, but exposure to triple-A-rated debt backed by pools of such loans, debt which turned out not to be risk-free at all.[57] Therefore , ones can say that BASEL III doesn't possesses the strength to prevent the future crisis, but even might cause further problems which directly or indirectly might create preconditions for another financial and economic crisis. In the following there some observations related to the weakness of the BASEL III related to the resistance to the financial crisis:

1. Basel III doesn't address, the calculation of risk-weights which turns out to be the principal contribution of Basel II to the last financial crisis.

In fact, the whole concept of risk weighting is based on the idea that some assets are riskier than others and those banks should hold more capital against risky assets than they do against much safer assets, as the loans to the governments are. Risk, moreover, was calculated primarily by reference to the rating assigned by one of the recognized ratings agencies. The intentions of the Basel II reform was to discourage banks from lending to risky enterprises, and to encourage the accumulation of apparently risk-free assets

That makes a certain amount of sense, but there are some main problems with it:

- It's backwards-looking: it considers that the level of the risk assessed at certain securities will continue to be the same in the future, i.e.(the securities which have been risky in the past will continue to be risky in the future) which is not necessarily true.
- Basel III certainly keeps the backward looking risk weighting approach, but it did dramatically increase the risk weighting on the assets that brought down many big banks in the previous crisis (CDOs of

[57] Anthony Randazzo : "Basel III Misses the Point; Bankers Will Still Cheat the Rules" , 1 pg.

ABS). And, probably more importantly in the long run, it removed the major source of arbitrage under Basel II, the disparity in treatment between securitisations in the trading book and the banking book.

- The BASEL III concept and its requirement are easy to be misused. Namely, the consequence of this Basel II reform was to discourage banks from lending to risky enterprises, and to encourage the accumulation of apparently risk- free assets. This was a primary contributor to the structured finance craze, as securitisation was a way to "manufacture" apparently risk-free assets out of risky pools. All this brought banks to collapse and illiquidity.

Since it did not change this risk-weighting, Basel III effectively doubles the problems which were indentifies at Basel II. Banks will need to hold more common equity than ever—against their risk-weighted assets. That will increase their incentive to find low-risk-weight assets with some return, since these assets can be leveraged much more highly than risky assets. Furthermore, lending to governments still carries a risk-weight of zero. So, one result of Basel III could be to encourage banks to increase their lending to governments at the margins of zero-risk-weight status.

2. The new system of BASEL III is overly dependent on the decisions of the regulators. While banks will have to keep a minimum of 4.5% of common equity and 6% of Tier 1 capital, they will also be subject to a 2.5% "capital conservation buffer. This buffer will be activated even when the bank is in good times, so to assure the bank's financial stability during financial crises.

However, within BASEL III there's no objective trigger point , in terms of time when banks will need to build up the buffer and when they will be allowed to draw on that capital if needed. This decision will be left up to regulators in each individual country. Trusting regulators to act on their authority takes some willpower.

For the concept which is intending to prevent future bank failures as BASEL III intends to be, it is too gullible or naïve to believe and left only to the regulators to decide and precise the time for when banks should hold more capital or even not. More important, the new regulatory scheme could fail in several ways.

The sad truth is that there is no set of rules that will ensure the solvency of the banking system, or its resiliency in a crisis. In a competitive market, banks have no choice but to seize any available opportunity to increase their return on capital. That means that regulators need to be dynamic in their response to changes in the marketplace, and anything that appears to generate returns with low risk should raise a red flag. Banks should be able to set their own capital requirements, but if the government is going to do it for them, then a single, simple, significant reserve level would avoid depending on regulators to time the market and help investors more easily understand the safety and soundness of banking institutions.

3. The rules and target given for the risk weights are pretty arbitrary and no special arguments is given about it. In fact it is not explained how it was calculated and whether equity to risk-weighted assets of 4.5% is high enough? Or whether the 2.5% buffer will hold up in financial storm?

There different opinion about it . The Shadow Financial Regulatory Committee[58], based in Washington, DC, released a statement arguing that the minimum common equity ratio was too low, since most of the financial institutions were over or at that ratio during the crisis. However, Germany was voicing concerns that proposed levels were too high, which is understandable, as Deutsche Bank had one of the lowest capital reserves right after the financial crisis . Further still, the capital ratio requirements are going to be relatively meaningless if the assets they're measured against get overvalued. This means ensuring proper accounting methods, which the Financial Accounting Standards Board has been grappling with, but failed to get right during the crisis.Even if there was a good defense for the agreed upon percentages, the choice of arbitrary risk weights is not efficient tool that doesn’t seem appropriate for the dynamic nature of the global banking industry.

4. The criticism on the BASEL II complexity is even exceeded with” four layers of capital requirements “indicated in BASEL III. It should be remembered that the failure of capital requirements wasn’t that they were set too low, but that they were too static and got out-navigated

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[58] Slovik, P. and B. Cournède (2011), “Macroeconomic Impact of Basel III”,pg 4

by a market that took advantage of the over complex nature of the old system to build up the risk right in front of the regulators. 5. A new regulatory scheme reduces bank profitability, creating a fundamental misunderstanding of how a competitive economy works. Regulation, by erecting barriers to entry, reduces competition. Those banks who are able to meet the regulatory requirements should be even more profitable than before because of lower competition. This means that, the banking sector as a whole might be less profitable under Basel III than it was before, but only if less capital in aggregate was allocated to the banking sector.

Individual banks will still need to attract investors—more common-equity investors than ever, in fact—and those investors will demand a competitive rate of return. No bank regulation can change that.

6. Basel III (like BASEL II) is a risk-based capital regime. Alongside reviewing capital strategies, banks should remember regulatory anticipations of continued improvements to risk management and the risk models supporting the capital calculations. Capital is only one lever to avoid future financial crises – regulators also continue to focus on risk management and governance underpinning a robust financial sector. Institutions that do not show a similar focus are likely to find themselves subject to even greater regulatory scrutiny.Even well-capitalised banks in Europe and the US could find some of the requirements demanding. The result could be reduced credit availability or increased cost of credit .

7. Therefore the new rules from BASELIII might force certain overleveraged and smaller banks to restrict access to credit, at least temporarily. In particular, this is likely to create tighter credit conditions for small and medium-sized firms, and for start-up businesses. It would have bad impact on the banking and business sector in transitional economies, where the small and medium enterprises are the driving wheel of the economy, while the banks are practicing conservative banking with limited or no instruments for risk transfer or hedging.

8. New rules on trade financing are likely to result in tighter trade credit conditions, encouraging companies to use less secure instruments.

In fact , Basel Committee is proposing to increase the risk-

weighting attached to all off-balance sheet items from the current 20% to 100% or their capital for asset-backed loans will be increased five times more. As the definition of off-balance sheet items include standby letters of credit and trade letters of credit (among others), the risk-weighting of traditional trade finance instruments (which represent around 30% of world trade) is set to increase significantly as well. The implication of this proposed rule is that banks will face a five-fold increase in the cost of trade finance. This will leave financial institutions with two options: either they will pass the costs onto their customers, or they will have to focus on other, more profitable activities and reduce their trade credit exposure, thus restricting access to letters of credit. In either case, trade financing conditions are likely to affect mostly the business with exposure to emerging markets, as letters of credit are usually employed in trade transactions with firms based in developing economies. So, the risk that this five-fold increase in the credit conversion factor for trade credit instruments might significantly restrict access to trade finance and therefore negative knock-on effects on world trade.

9. The last , but may be the most important concern is that Basel III leaves unanswered questions about non-bank financial institutions, as they fall beyond the scope of the new regulations. Shadow banking (such as insurance firms, hedge and pension funds, and investment banks) played a central role in the latest financial crisis and has become a major provider of credit. However, the Basel Committee's proposals do not concern this increasingly important sector of the financial system. This means that Basel III affords shadow banking a competitive advantage and is likely to incentivise risk taking in this sector, which can be easily transferred over the banking industry and create the condition for the new financial crisis.

Conclusion

The implementation of Basel III might be followed with certain risks, which might have negative impact on financial stability and progress of the economy. The tightened criteria for BASEL III might have certain negative impact on economic growth in the medium to long term period. It is also important to mention that so called "Shadow

banking (such as insurance firms, hedge and pension funds, and investment banks) played a central role in the latest financial crisis and has become a major provider of credit.

In fact Basel III affords shadow banking a competitive advantage and is likely to incentivize risk taking in this sector. Moreover, in the event of an insolvency crisis in the non-bank financial sector, the banking system will be unlikely to remain immune to the risk of contagion.

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