Banking and Capital Markets

Preparing for take-off

Reaction to the Basel III announcement of September 2010

On 12 September 2010 the Basel Committee announced broad agreement on a package that will significantly increase the capital and liquidity required by banks. The package has attracted huge interest around the world and maps an agreed flight-path for the sector for the next ten years.

A big step forward – but a long way to go

The new requirements are a big step forward in the development of the post-crisis regime for banks and, through that, a step towards reducing the risk of a second severe market crisis. Many commentators suggest that the job has now been done and that the banks and regulators can turn their attention elsewhere. In our view this is far from the case.

First, **the announcement cannot work on its own**. As the regulators recognise, financial stability is about far more than capital and liquidity – higher ratios alone will never take all the risk out of the banking system. Banks will still fail but regulators are working on other steps that will reduce the risk of failure harming depositors, taxpayers, or the system as a whole. They include:

- Improved trade settlement arrangements and effective netting of interbank exposures, to minimise the risk of a domino effect in bank failure.
- Better arrangements for resolving failing banks quickly, including development of recovery and resolution plans as well as reducing the complexity of the legal framework.
- Greater clarity over the management of the various separate entities within a banking group.

Second, **there is much that is (necessarily) incomplete**. For example, although the leverage ratio is broadly defined and the implementation timetable proposed, there is a lot of important detail to be filled in. Similarly, the countercyclical capital buffer that banks will need to meet has only been pencilled in (although this has been announced in principle just two days after the consultation period ended, which raises questions on the purpose of the consultation). Both of these could significantly impact a bank's business model and strategy.

Third, **there is much more for the regulators to do**.
For example, they still need to:

- Complete and calibrate the liquidity and leverage constraints.
- Develop clear guidelines as to how countercyclical capital buffers may be applied, and how and when they may be released.
- Get the philosophy right on the Net Stable Funding Ratio (NSFR) and define the requirements in detail. The NSFR is particularly problematic, with scope for unintended consequences as a single ratio could be applied to a wide range of business models.
- Agree the approach for systemic banks which may include an additional capital surcharge.
- Strengthen supervision: stronger regulation will only work with equally strong supervision of the new requirements.
- Achieve consistent international implementation, and avoid super-equivalence, for example in relation to the countercyclical buffer.

Fourth, **there is much for banks to do**. Although banks now have some firm numbers and can start business planning with greater certainty, each bank will need to think through the unique implications of the changes for itself and what its response should be. For example, banks will need to:

- Plan capital and liquidity needs in the new world. They will need to plan soon how they want to meet the new ratios, and deal with issues specific to their own position, for example phasing out existing (and increasingly expensive, from a regulatory perspective) non-equity tier 1 and tier 2 instruments and replacing them with funding appropriate to the new regime.
- Ensure that they have robust capital management processes. The new regime will cause many banks to look again at how these operate and how they allocate capital resources (even to the extent of changing business models).
- Strengthen governance and risk management, for example in the area of liquidity risk, where many solutions to date have been tactical.

Despite the phasing-in period for the new minimum ratios, the regime will make significant **financial demands on banks**.

- Capital and liquidity levels have already increased significantly, but for many, more will be needed. Some commentators are creating a false sense of security by:
  - Equating Basel II ratios with Basel III ratios.
  - Ignoring the management buffers that banks hold above the regulatory minimum.
  - Implicitly assuming that the definitional changes will have minimal impact.
- The phasing-in period illustrates how long the Basel Committee believes it will take some banks to generate capital to support lending growth and meet the new regime. However, the Basel Committee has not published any quantitative assessment of the level of additional capital that might be needed and how this relates to likely supply over the transition period.
- A number of banks need to wean themselves off government support, whether in the form of capital injections to cover losses, or access to state-sponsored provision of liquidity.
- For many institutions the liquidity challenge is likely be greater than the capital challenge. This is an area where supply constraints (for example the availability of deposits, medium-term funding and high-quality liquid assets) are likely to be a key issue.

The **implementation timescales** for the new requirements may appear extended. However, in practice, we believe those banks that can do so will want to tackle the balance sheet consequences of the new regime sooner rather than later. Comparisons with peers are likely to be more important than the formal regulatory timetable.

As a point of detail, we note that some of the proposed transition arrangements are out of line with current EU legislation and present a challenge to EU banks which had been counting on CRD II. For example the Capital Requirements Directive (CRD) does not include the 'sliding scale' of eligibility of hybrid instruments during the transition period. It also proposed grandfathering hybrid capital instruments issued before 31 December 2010 – Basel only applies grandfathering to issues before 12 September 2010.

We believe that **feedback mechanisms** are critical during implementation of the new approach. The regulators, working with the support of the banks, must be able to monitor progress, identify issues and take timely corrective action during the transition phase.

Aside from the quantum of the new rules, **we believe that there are inherent dangers in too much focus on rule-driven capital ratios**. We also believe that the various buffers ('a buffer on a buffer on a buffer') now embedded in the new regime are not the best way to protect the financial system, because the approach:

- Lacks transparency for investors.
- Risks moral hazard, as the Pillar 1 style removes the onus of thinking critically about risk and maintaining sufficient capital to absorb stress events away from banks (and also, arguably, supervisors).
- Uses a 'one size fits all' approach that is potentially blind to the range of different business models employed by banks, or the degree of conservatism which they adopt.

We believe that a more appropriate alternative would be rigorous application of Pillar 2, which requires banks to assess how much capital they need to cover all of their material risks and to forecast this under a forward-looking stress scenario, and for supervisors to assess whether this is adequate. This places responsibility squarely on the shoulders of the board of each bank, and allows for a tailored approach that properly reflects the unique circumstances of each institution.

This requires a consistent international approach and suitably skilled, experienced and tough supervisors, but would incur a fraction of the cost of imposing standard capital buffers on all banks. More importantly, we believe that this would achieve a healthier focus on risk and risk management. One thing that we know for certain is that the next crisis will not look like the last.

Looking ahead **to next steps**, it should be remembered that the proposals are still subject to approval by the G20, and the key milestone will be the G20 meeting in November 2010. In addition, a series of other initiatives are moving forward, notably:

- The consultations on capital buffers and 'gone concern' capital, to be completed around the end of 2010.
- The calibration of the LCR, NSFR and the capital charge for CVA, to be completed at the end of 2010.
- National and regional changes, such as the new EU white paper on bank governance at the end of 2010.
- Accounting standard changes targeted for 2011 (for example relating to forward-looking provisions).

We would be pleased to discuss the implications of Basel III with you further. Please get in touch with your usual contact within PricewaterhouseCoopers or one of those listed below:

Contacts

Asia Pacific

Christophe Cadiou
PricewaterhouseCoopers (Japan)
christophe.cadiou@jp.pwc.com
+81 3 6266 5699

Richard Groves
PricewaterhouseCoopers (Australia)
richard.groves@au.pwc.com
+61 2 826 61499

Chris Matten
PricewaterhouseCoopers (Singapore)
chris.matten@sg.pwc.com
+65 6236 3878

Europe

Richard Barfield
PricewaterhouseCoopers (UK)
richard.barfield@uk.pwc.com
+44 20 7804 6658

Patrick Fell
PricewaterhouseCoopers (UK)
patrick.w.fell@uk.pwc.com
+44 20 7212 5273

Ullrich Hartmann
PricewaterhouseCoopers (Germany)
ullrich.hartmann@de.pwc.com
+49 175 265 0 257

Monika Mars
PricewaterhouseCoopers (Switzerland)
monika.mars@ch.pwc.com
+41 58 792 1622

North America

Jason Boggs
PricewaterhouseCoopers (Canada)
jason.boggs@ca.pwc.com
+1 416 941 8311

Diana Chant
PricewaterhouseCoopers (Canada)
diana.chant@ca.pwc.com
+1 416 365 8207

Fernando de la Mora
PricewaterhouseCoopers (US)
fernando.de.la.mora@us.pwc.com
+1 646 471 5257

Shyam Venkat
PricewaterhouseCoopers (US)
shyam.venkat@us.pwc.com
+1 646 471 8296

www.pwc.com

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2010 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" and "PwC" refer to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL). Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm's professional judgment or bind another member firm or PwCIL in any way.