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Capital management in banking: The way forward

Looking ahead, the future for banking is becoming clearer. It is a future of more capital, more liquidity and less risk. In this article we look into Basel III and the challenges firms will face as these changes come into operation.

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The future of banking is becoming clearer. It is a future of more capital, more liquidity and less risk. And, inevitably, it is a future with lower returns on capital, higher costs of doing business and slower growth with ultimate effects to be felt by shareholders and end consumers. Greater scrutiny by investors, regulators and other stakeholders regarding balance sheet usage is also expected.

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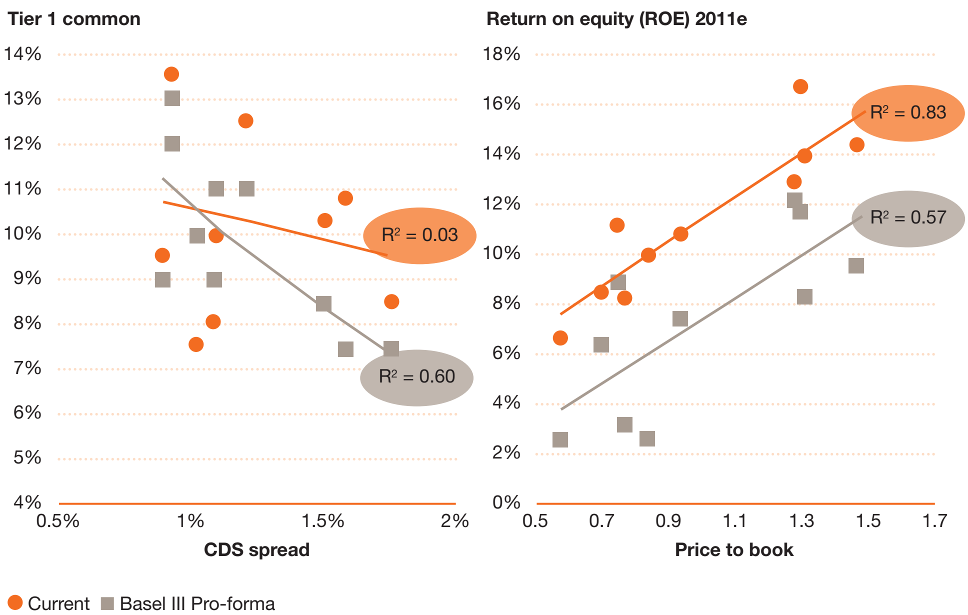
Basel III is set to redraw the banking landscape. It will have a profound impact on profitability and force many banks to transform their business models. It will also require firms to undertake significant process and system changes.

The good news is that most banks are expecting to meet the more stringent requirements without raising additional capital, as reported in recent bank earning releases. In addition, the Basel III framework does not begin to come into operation until January 2013 and its full effects will not be felt before January 2019, when the new regime's transitional period ends. Nonetheless, it is critical that firms start to reset their business models now to adapt to the new capital and liquidity standards. By doing so, they can not only start to tackle Basel III's many challenges but also keep abreast of the competition.

The markets have already started to price Basel III impact. As shown in Figure 1, the credit default swap (CDS) market already pays more attention to banks' pro-forma capital adequacy levels under Basel III rather than to the current standards. As the equity markets better understand the return on equity (ROE) impact of new standards and bank strategies become more clearly articulated, investors will be in a better position to analyse and compare risk-adjusted performance and thus to drive stock valuation differences in due course. Recent US Federal Reserve guidance requiring Basel III pro-forma analysis to restore dividend and buyback programs is another sign that Basel III is here.[1]

Figure 1: Basel III market impact analysis



Source: PwC analysis based on 3Q10 bank Tier 1 common disclosures, CDS information from Markit Partners and ROE and P/B from Bloomberg as of November 2010.

R^2 represents the statistical explanatory power of the relationship, the higher R^2 the higher the correlation.

1 Revised Temporary Addendum to SR letter 09-4: Dividend Increases and Other Capital Distributions for the 19 Supervisory Capital Assessment Program Bank Holding Companies – 11.10.

Figure 2: Basel III market impact analysis

The new framework:

- Raises the quality, consistency and transparency of the capital base through stricter rules on eligibility of instruments to be included in (core) Tier 1 capital.
- Enhances risk coverage by strengthening counterparty credit risk capital requirements arising from derivatives, repurchase transactions and securities financing.
- Supplements risk-based capital requirements with the addition of a non-risk-based leverage ratio as a backstop measure.
- Reduces procyclicality and promotes countercyclical capital buffers through a combination of forward-looking provisioning and capital buffers.
- Introduces new global liquidity standards that include a stressed liquidity coverage ratio and a longer-term structural liquidity ratio.
- Addresses systemic risk and interconnectedness, with more specific proposals yet to be developed.

The key changes

Basel III establishes tougher capital standards through more restrictive capital definitions, higher risk-weighted assets (RWA), additional capital buffers and higher requirements for minimum capital ratios. (For further details, see Figure 2). Primary sources for RWA inflation include trading market risk, securitisation exposures and over the counter risk (OTC) derivatives counterparty exposure. As well as rethinking their business models, many banks will need to achieve upgrades in the areas of stress testing, counterparty risk and capital management infrastructure.

The reforms will impact most heavily on banks with large capital markets businesses. Higher capital requirements will primarily come from trading books, securitisations, securities lending and OTC derivatives.

Basel III also establishes new liquidity standards that will drive changes in banks' balance sheet composition to limit illiquid assets, restrict wholesale or unstable sources of funding and manage higher funding costs. These new standards will have a broad impact across most banks, particularly those that focus on commercial and wholesale banking activities.

Business model implications of Basel III

Basel III's increased capital and liquidity requirements will have significant systemic and idiosyncratic effects across the banking industry and capital markets. Higher capital and funding costs should incentivise banks to move toward different business models. Some examples of anticipated changes and opportunities include:

- Shrinkage of securitisation market and structured credit businesses, putting pressure on originate-and-sell lending businesses.
- Reduced volumes in OTC derivatives and migration to clearing houses.
- Emphasis on customer facilitation activities with reduction of trading inventories, particularly of less liquid assets such as low credit quality, commodity and emerging market instruments – thus reducing the liquidity of those market segments and resulting in block trading opportunities.
- Expansion of businesses dedicated to trade clearing, trade processing and servicing.
- Transfer of proprietary trading to hedge funds.
- Increased competition from less regulated firms and potential loss of human capital to new entrants.
- New structuring opportunities for banks considering contingent capital instruments.
- Pricing strategies will be altered in those businesses that over the medium term are not able to deliver acceptable returns.
- Cost efficiency will more than ever be a key differentiator.

With regard to liquidity, banks are bound to face greater competition – and increased costs – in respect of retail deposits. Emphasis on deposit gathering will result in increased competition, product innovations and enhanced customer services. Repo financing and lending of securities positions will become more costly. Wholesale loan products, including committed credit and back-up liquidity lines, will be rationalised, pushing more borrowers to the securities markets. It is, at the current time, difficult to predict the future structure of the wholesale funding markets.

Banks should assess the impact of the new rules on their capital adequacy through a comprehensive capital planning and optimisation/mitigation process.

The cost of funding is likely to increase for all institutions, with materiality depending on balance sheet management and funding strategies.

Finally, firms will be obliged to invest in substantial upgrades in IT infrastructure, reporting systems and data management. The upgrade of capital management practices should help banks bridge risk and strategy to address business model challenges and opportunities.

Capital management strategies

Banks should assess the impact of the new rules on their capital adequacy through a comprehensive capital planning and optimisation/mitigation process. Banks with large sales and trading businesses have estimated a total RWA average increase of 60% from current levels under Basel III.[2] This substantial increase will be compensated by mitigation efforts estimated at 25% of total RWA on average.

The size of the capital increase impact, the need to deliver promised RWA savings and the limited room for volatility surrounding compliance with minimum Basel III capital targets all reinforce the need for RWA optimisation programs, These programs (see Figure 3 for illustration) should do the following:

- Estimate RWA impact by business line and product including sources of increase.

Figure 3: RWA optimisation and mitigation program overview

Line of business		RWA mitigation and optimisation impact					Potential RWA mitigation strategies	RWA projected savings				Business model impact
		VaR/IRC	CCR	50/50	Model	Data		'10	'11	'12	'13	
Sales and trading	Equities	◔	◔	○	◔	◑	• Position/Securitisation run-off • Reduction of trading and investment positions • Increased use of hedging and collateral • Reduced market/credit risk limits • Derivatives business from OTC to exchange • Pricing/data/model adjustments					
Sales and trading	Fixed income	●	◑	●	◑	◑	• Position/Securitisation run-off • Reduction of trading and investment positions • Increased use of hedging and collateral • Reduced market/credit risk limits • Derivatives business from OTC to exchange • Pricing/data/model adjustments					
Sales and trading	Commodities	◑	◑	○	◑	◑	• Position/Securitisation run-off • Reduction of trading and investment positions • Increased use of hedging and collateral • Reduced market/credit risk limits • Derivatives business from OTC to exchange • Pricing/data/model adjustments					
Treasury/cash management services		◔	◑	○	◔	◑	• Position/Securitisation run-off • Reduction of trading and investment positions • Increased use of hedging and collateral • Reduced market/credit risk limits • Derivatives business from OTC to exchange • Pricing/data/model adjustments					
Retail banking		○	○	○	◑	◑	• Position/Securitisation run-off • Reduction of trading and investment positions • Increased use of hedging and collateral • Reduced market/credit risk limits • Derivatives business from OTC to exchange • Pricing/data/model adjustments					

n.b. These circles are an indication of the impact (the fuller the circle the higher the potential impact).

2 As reported in Q3 2010 earning releases of Bank of America, Citi, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Barclays, Deutsche Bank, Credit Suisse and UBS.

- Evaluate alternative RWA mitigation/de-risking and capital re-allocation strategies.
- Assess impact on business model and marginal risk-adjusted returns of proposed actions.
- Optimise mix of RWA initiatives and plan savings in capital requirements over a three-year horizon.
- Evaluate overall capital strategy including organic generation in combination with their dividend and share repurchase programmes and various proposed RWA mitigation scenarios.
- Calibrate capital structure, emphasise high-quality equity, manage impact of new Basel III deductions, phase out hybrid capital instruments and evaluate contingent capital instruments.

Liquidity and funding strategies

For many institutions, Basel III's liquidity challenge is likely to be greater than its capital challenge. Supply constraints – such as the availability of deposits, reliance on wholesale funding sources and high-quality liquid assets – are likely to be a key issue. The impact of the liquidity proposals is less known and banks have not yet disclosed pro-forma impact as liquidity standards will only start to be phased in by 2015.

In anticipation of the impact of Basel III on liquidity, firms should seek to reduce the number of their businesses with an unfavourable liquidity treatment; raise the liquidity of their investments; raise their retail deposits; increase their additional long-term debt and capital; reduce their committed credit and liquidity facilities; reduce their wholesale credit; and adjust their pricing to compensate for the higher cost of funding.

A planned response to Basel III

Large banks will, in all probability, seek to manage their businesses to Basel III's requirements prior to the proposed deadline of January 2019 for full implementation. Firms should, therefore, look to tackle the balance sheet consequences of the new regime sooner rather than later. Before setting out on this challenging journey, however, they should equip themselves with a roadmap that sets out both short- and long-term goals for upgrading their capital management strategies and practices.

One of the immediate next steps management should consider is the development of a capital plan under the new Basel III regime which considers potential impact on capital level, liquidity position and overall key financial metrics. The plan should also contemplate capital and liquidity management strategies to be employed, so as to ensure compliance with the new requirements, including changes in capital models and related infrastructure.

Management should also seek to anticipate changes in their firm's business model, product offering and client pricing strategies. They should assign a finance/risk/business line team to plan key implementation steps and continue providing comments to regulators on consultative documents. Management should also communicate with investors to ensure transparency in relation to Basel III's impact and the bank's mitigation strategies.

2015

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Looking further ahead, if banks are to achieve an effective upgrade of their capital management governance and processes, a successful integration of Pillar 2/ICAAP programmes and the new rules will be critical.

Looking further ahead, if banks are to achieve an effective upgrade of their capital management governance and processes, a successful integration of Pillar 2/ICAAP programmes and the new rules will be critical. Firms need to continue to assess how much capital is required to cover all of their material risks and to generate forecasts that utilise forward-looking stress scenarios. Given the new regime's inclusion of conservation, countercyclical and systemic buffers, banks should reconcile their current management buffers with the projected buffers under Basel III. Firms should also benchmark their ICAAP governance and processes, including IT infrastructure and reporting components, to supervisory expectations.

Banks beware

While banks should begin to prepare for the new framework without delay, they also need to be mindful of areas that require further clarity. Although the leverage ratio is broadly defined and the implementation timetable has been proposed, there is still a lot of important detail to be filled.

More information is also expected in relation to the countercyclical capital buffer that banks will need to meet. There are as yet no guidelines as to how such buffers may be applied and how and when they may be released. An approach for systemic banks by local regulators has yet to be agreed, with the eventual solution perhaps including an additional capital surcharge such as that proposed by Swiss regulators.

Liquidity standards need to be completed and calibrated. Given its large potential consequences in business models, the constraints related to the net stable funding ratio will demand particular attention. Banks should also keep in mind the need to integrate their response to Basel III with other initiatives, such as impact of the overall regulatory reform (e.g. Dodd-Frank Act), migration of derivatives to clearing houses, improving trade settlement arrangements, achieving more effective netting of interbank exposures; developing recovery and resolution plans; and establishing greater clarity over the management of the various separate legal entities within a banking group.

An uncertain future

At the date of publication, Basel III's proposals had been already endorsed by the G20. A number of other initiatives – including consultations on capital buffers and 'gone concern capital'; calibration of the lowest current rate (LCR), net stable funding ratio (NSFR), and the capital charge for credit value adjustment (CVA); and various national and regional changes (such as the new EU white paper on bank governance) – are scheduled to conclude at the end of 2010. Meanwhile, accounting standard changes (relating, for example, to forward-looking provisions) are targeted for 2011.

Thus, while the picture is becoming clearer, the future of banking is still shrouded in uncertainty. Though firms may be tempted to play a waiting game, they should in fact already be taking steps to ready themselves for the demands of Basel III.

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