BANKING ON KNOWLEDGE

Basel III compliance is a balancing act for stakeholders

By Dr R Seetharaman

The GCC region is working towards compliance with Basel III Framework. During Global financial crisis many banks, despite having adequate capital levels, experienced difficulties as they did not manage their liquidity in a prudent manner. A light touched regulation along with excessive on and off balance sheet leverage increased the systemic risks. Basel III Framework aims to address these challenges.

Recently Qatar Central Bank (QCB) has come out with instructions for implementing capital adequacy and liquidity coverage for conventional banks based on the Basel III guidelines issued by the Basel Committee on Banking Supervision (BCBS). The regulatory capital will consist of the sum of Tier 1 ("T1") Capital: going-concern capital and Tier 2 ("T2") Capital: gone-concern capital.

The Tier 1("T1") Capital: going-concern capital will consist of Common Equity Tier 1 capital ("CET 1") and Additional Tier 1 ("AT1"). The minimum capital requirements for Qatari banks are: a) CET1 must be at least 6.0% of risk weighted assets at all times, b) T1 Capital must be at least 8.0% of risk weighted assets at all times and c) Total Capital (T1 Capital plus T2 Capital) must be at least 10.0% of risk weighted assets at all times.

The capital buffers have been outlined in addition to the minimum capital requirements, which could be used at the time of stress and a breach in capital buffers will lead to constraints on distributions but not on the operations of the bank. The Capital buffers have to be met solely from CET 1. The Capital buffers include Capital conservation Buffer – 2.5% of Risk Weighted Assets (RWA), Countercyclical Buffer – 0% to 2.5% of RWAs and Domestic Systemically Important Banks

(DSIBs) Buffer – 0% to 3.5% of RWAs.

As of 1 January 2014, conventional banks in Qatar will be required to meet the new requirements and the Countercyclical Buffer and DSIBs Buffer will be implemented from January 2016 as per BCBS implementation timelines.

The Central Bank of Kuwait has approved a minimum capital adequacy ratio of 13% with phased-out application; 12 % in 2014, 12.5% in 2015 and 13% in 2016.

Liquidity coverage ratio (LCR) aims to ensure that banks maintains an adequate levels of unencumbered high-quality liquid assets that can be easily converted into cash to meet its liquidity needs for a stressed period of 30 days. It is determined by dividing stock of high quality liquid assets (HQLA) by total net cash outflows.

The HQLA also includes residential mortgage-backed securities rated AA or higher, corporate debt securities rated A+ to BBB-, and unencumbered equities that meet certain conditions. Total net cash outflows are the total expected cash outflows (less) total expected cash inflows in the specified stress scenario for the subsequent 30 calendar days.

The minimum LCR in 2014 would be 60% and increase by 10 percentage points per year to reach 100% in 2018. The longer timetable for applying the LCR should ensure that the ensuing costs on banks and their clients' products are spread gradually. It also gives greater flexibility to build up cash buffers.

In the beginning of this year, world banking regulators have stated they would soften the terms of the leverage rule meant to ensure banks' soundness. Basel III had introduced leverage ratio as a measure to check the capital gearing in the balance sheets of the banks.

The Basel committee will still require banks to hold capital equivalent to at least 3% of their assets. The biggest beneficiaries of the changes appear likely to be banks most involved in securities and derivatives markets. Changes to the leverage rule give lenders more scope to use an accounting practice known as netting to calculate the ratio, and ease proposals on how lenders determine the size of their off-balance sheet activities.

Basel III enables building up of high quality capital base, restricting excessive on and off sheet balance leverage and strengthen liquidity. Basel III focuses on improving risk management and governance as well as strengthening banks' transparency and disclosures.

The reforms to capital and liquidity were also intended to improve resilience in the banking sector. Basel III regulations are changing banking business models across the globe and hence various stakeholders such as shareholders, board members, management, sustomers and regulators should take cognizance of this. Basel III compliance is a balancing act for various stakeholders.

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