COLUMN
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Regulatory realignment is the solution for financial stability

THE GLOBAL DEVELOPMENTS in Basel 3 focus on increasing the quality and consistency of capital, increase counterparty credit risk charges, increase the quantity and quality of liquid assets and funding profile of banks and develop the guidelines for systematically important banks. The bank's Tier 1 capital is mostly made up of ordinary shares termed "Common Equity Tier 1". Non-common Equity Tier 1 capital is subject to strict conditions and must be capable of supporting a bank on a going concern basis. Significant changes are also made to Tier 2 capital. The Tier 1 capital ratio is to be increased from the current four per cent of risk weighted assets to six per cent.

The Common Equity Tier 1 ratio is to increase from two per cent to 4.5 per cent. The counterparty credit risk charges are increased by ensuring that derivatives, repos and securities financing activities which are not cleared with a central counterparty are subject to, one, much higher capital requirements for counterparty credit risk than currently apply and, two, more robust margining, collateral and disclosure requirements. For systematically important banks, the additional loss absorbency requirement will range from one per cent to 2.5 per cent Common Equity Tier 1 depending on a bank's systemic importance with an empty bucket of 3.5 per cent.

In relation to liquidity risk, financial services organisations should monitor balance sheet funding gap analysis across various maturities. They should exclusively monitor the funding gap on foreign currency book. The liquidity ratio and credit ratio should be closely monitored and reported to senior management. In relation to interest rate risk, financial services organisations monitor the interest rate sensitivities across various buckets in its balance sheet.

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The implications of a shift in interest rate movements are closely evaluated to support strategic balance sheet management. In relation to market risk, financial services organisations closely monitor the investment book comprising of fixed income and equities. Stress test analysis, value at risk analysis, sensitivity analysis and yield curve analysis are performed periodically to monitor the performance of investment book. Financial service organisations also closely monitor the concentration risk both on the lending and funding side.

In relation to forex risk, financial service organisations monitor the open positions in the proprietary books. Financial risk departments actively support in the area of liquidity risk, market risk, currency risk, interest rate risk and overall balance sheet management.

Regional banking regulations are undergoing change in line with global reforms. The UAE had recently brought in regulation pertaining to liquidity. The key developments include at least one board member should have detailed understanding of liquidity risks management. A bank must incorporate liquidity costs, benefits and risks into the product pricing and approval process for all significant business activities.

A bank must have a formal contingency funding plan that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. Banks must maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios. Banks are required to develop a transfer-pricing framework to reflect the actual cost of funding. Interim ratios such as liquidity asset ratio and use of funds to stable resources ratio have been introduced until Basel 3 ratios come into place.

Basel 3 requires banks to maintain two liquidity parameters — one for short term resiliency called as liquidity coverage ratio and the other for longer term resiliency called net stable funding ratio. Banks will be required to complete a liquidity report to enable the central bank to monitor effectively the liquidity positions at banks and to take appropriate and timely action at early signs of a liquidity stress. Hence, regulatory realignment is the solution for financial stability. The appetite to push towards Basel III compliance could provide "a great opportunity" to create an active money market in the UAE which would be a boost for corporates. Hence regulatory realignment is the solution for financial stability.

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