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Abstract

Traditionally, banks have been the main pillar of financial intermediation and, consequently, a fundamental source of systemic risk, which in its worst forms have resulted in financial crises. In times of economic downturns, financial institutions welcome governmental curative intervention, which in many cases has proven to be misappropriated. One big intervention was Basel II, which has been criticized by many sceptics already in the early 2000s and has been accused of having contributed to the late-2000s financial crisis. Basel III has been then elaborated on the grounds of the obvious inappropriateness of Basel II. The framework sets out higher and better-quality capital standards, better risk coverage, leverage ratios as a backstop to the risk-based requirements, measures to promote the build-up of capital that can be drawn down in periods of stress and the introduction of two global liquidity standards. However, Basel III and its requirements have been questioned. For one thing, Basel III bases its requirements on those formulated in Basel II, possibly still exacerbating financial and monetary imbalances between industrialized and lower-income countries. For another, it creates ambiguities that regulators and the banking industry try to clarify. These regard, for instance, new liquidity standards and the containing leverage that may increase capital costs and, potentially, lower profitability. Furthermore, Basel III may create problems for emerging countries, which may face shortened lending volumes, influencing trade dynamics and financial flows between industrialized and emerging economies.

Introduction

Banks contributed to the late-2000s financial crisis in their fundamental role as financial intermediates. For one thing, the crisis revealed that banks had insufficient amounts of capital and that the quality of capital at their disposal was inadequate to absorb losses during critical phases. For another, the procyclical effect of Basel II capital requirements, the declared superiority of banks' internal risk models, and the lacking credit risk assessments by rating agencies have been strongly criticized. Despite the fact that Basel II may not have played a decisive role in inducing the financial crisis (Basel II rules were indeed still in process of being approved and implemented when the crisis started), its shortcomings have led to an enhanced framework, Basel III, to be introduced. Hence, Basel III has been developed in response to the financial regulatory deficiencies that materialized during the financial crisis. The aim of this paper is to put Basel III as a global regulatory standard on banks and its measures into perspective. In particular, this paper questions whether Basel III in its current form will be able to improve the banking sector's ability to deal with shocks arising from financial and economic stress, to reinforce risk management practices and governance, and to improve the banks' transparency and disclosures (Bank for International Settlements, 2012). The first section regards Basel III and its features; in particular, the contents as well as some structural barriers hampering its implementation will be discussed. Then, the implications of its adoption will be addressed. The second section also includes reflections regarding Basel III and its effects on lower-income countries. The last section discusses Basel II, its requirements and its limitations. To some extent, Basel III builds on the requirements of Basel II. Therefore, if the existing shortcomings of Basel II remain unchanged in the formulation of Basel III, stability and safety across the banking system may be endangered, further aggravating financial and monetary imbalances between industrialized and emerging markets.

Basel III and its Influence on Prudent Banking

About Basel III

On December 16, 2010, the Basel Committee on Banking Supervision (BCBS) issued the final text of the International Regulatory Framework for Banks—Basel III—containing global regulatory standards on bank capital adequacy and liquidity. The framework was adopted by the G-20 leaders a few weeks prior, at the November 2010 G-20 Summit in Seoul, South Korea.

The framework sets out higher and better-quality capital standards, better risk coverage, leverage ratios as a backstop to the risk-based requirements, measures to promote the build-up of capital that can be drawn down in periods of stress and the introduction of two global liquidity standards. The framework thus aims to increase the risk coverage of banks' capital frameworks for securitization, trading books, off-balance sheet vehicles and derivative-related counterparty credit risk exposure. It upholds the microprudential regulatory rules of Basel II (also called the International Convergence of Capital Measurement and Capital Standards), but superimposes them with macroprudential safeguards against systemic risk that can occur as the financial system continues to globalize and actors within it become more interconnected.

Basel III is expected to bring major changes across the global banking industry and even change their core business models and financial structure. Commentators are already expressing concern that it will be difficult to implement such far-reaching changes in the time frames provided. They are also concerned that different paces of implementation across jurisdictions will open large loopholes for regulatory arbitrage.

This section will briefly explore the contents of Basel III and discuss some of the structural barriers that need to be removed to provide for its implementation.

Increasing the Quality and Quantity of Capital

Basel III defines and takes steps to harmonize the financial instruments that can be considered eligible as regulatory capital. The Tier 1 capital requirements, which include common equity and a range of other, more strictly defined instruments, have been increased from 4 per cent to 6 per cent. Moreover, the minimum requirement for common equity, the higher form of loss absorbing capital, was raised by 2 per cent before the application of regulatory adjustments, to 4.5 per cent after the applications of regulatory adjustments. Tier 2 capital has been more strictly defined and is now placed to bear losses on a contingency basis or a going concern basis in the case of insolvency. Provisions for Tier 3 capital have been removed completely.

National implementation of these regulations is expected to begin in January 2013 and the Bank of International Settlements' member states are expected to have translated these provisions into national banking legislation by then. Note, however, that financial instruments that no longer qualify as regulatory capital (and non-common equity) under Tier 1 and Tier 2 are to be phased out by 2023.

An Added Capital Conservation Buffer

Basel III also introduces an additional capital conservation buffer of 2.5 per cent that is to be financed through common equity. When this buffer falls below 2.5 per cent in times of stress, banks are curtailed in their ability to pay dividends to shareholders and discretionary bonuses to employees until the buffer is restored.

In effect, when considered together, the increase in capital requirements for Tier 1 and Tier 2 and the capital conservation buffer call for a common equity ratio of 7 per cent and a total capital requirement of 10.5 per cent.

Countercyclical Capital Buffer

The Basel III rules also spell out a framework for the establishment and disbursement of a countercyclical buffer ranging between 0 and 2.5 per cent, funded through common equity or other risk-absorbing capital, which will, as quoted by the BCBS, “be implemented according to national circumstances” (Bank for International Settlements, 2011b). This measure appears to have been directly designed to dampen the procyclical nature of capital markets. During bull runs when underwriting is generous, credit is easy to secure; in times of downturn, the opposite is true. Credit losses lower the availability of capital, and the value of mark-to-market credit products is highly sensitive to market volatility. These trends can deepen the multiplier effects of a credit crunch and add impetus to contraction across the economy.

This measure is hence designed provide the banking sectors with protection, at the national level, from periods of excessive credit growth. As stated in a September 2010 Bank of International Settlements press release, “for any given country, this buffer will only be in effect when there is excessive credit growth that is resulting in a system wide build-up of risk.”

Additional Loss-Absorbing Capacity for Systemically Important Banks

In June 2011 the BCBS agreed on a consultative document setting out measures for global, systemically important banks, including a methodology for assessing systemic importance, the additional required capital and the arrangements by which they will be phased in. The assessment methodology is based on an indicator-based approach designed to increase the resilience of globally systemically important banks and create incentives for them to reduce their systemic importance over time. The methodology comprises five broad categories: size, interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity. The additional loss absorbency requirements are to be met with a common equity Tier 1 capital requirement ranging from 1 per cent to 2.5 per cent, depending on a bank’s systemic importance. These measures are to be introduced in parallel with the Basel III capital conservation and countercyclical buffers, between January 2016 and year-end 2018, becoming fully effective January 1, 2019 (Bank of International Settlements, 2011a).

The rationale here is that if a bank requires to be recapitalized with public funds or when it writes off or converts capital to remain solvent, it should be forced to convert non-debt capital into fully loss-absorbing equity. This, in turn, provides an incentive to market participants to be more prudent and conduct more scrupulous due diligence on banks and increase the likelihood of them being forced to convert debt into loss-absorbing equity in times of stress.

Basel III also provides for a new risk-invariant leverage ratio to act as a backstop for the increases in the quantity and quality of capital requirements. From 2015 onwards, a minimum Tier 1 leverage ratio of 3 per cent will be implemented during a parallel run period; based on this leverage ratio, this measure will be further calibrated with the view to its inclusion as a Pillar 1 capital requirement in 2018.

Global Liquidity Standards

Banks can fail not only from credit losses but also due to the lack of liquidity to fund their operations. This has prompted international regulators to introduce, for the first time, a global liquidity coverage ratio that will require banks to have sufficiently high-quality liquid assets to withstand a 30-day stressed funding scenario. This ratio is to be implemented in 2015.

The Basel III Accords also makes provisions for a net stable funding ratio—a longer-term structural ratio designed to address liquidity mismatches. The purpose of this standard is to complement the global liquidity coverage ratio by covering the entire balance sheet and providing an incentive for banks to use longer-term sources of funding.

Risk-Weighted Assets

The 2008–2009 financial crisis also demonstrates how re-securitization transactions (when a securitized product can be used as the underlying asset to another securitized instrument) can be particularly dependant on highly liquid markets. To safeguard against such instances, Basel III contains measures to increase the capital requirements by adjusting the risk weight of re-securitization exposures in relation to the securitization exposures, by harmonizing some credit conversion factors for specific liquidity facilities, by requiring more precise credit analysis of externally rated securitization exposures, and by disallowing the recognition of ratings that reflect guarantees or other support provided by banks.

Banks that use the Internal Models Approach are also required to extend the market risk capital requirement by calculating a stressed market Value at Risk. The rationale here is to reduce the procyclicality of the market risk capital requirements by expanding market risk capital requirements to account for periods of stress.

Basel III also improves counterparty credit risk frameworks. This includes more stringent requirements for measuring exposure, capital incentives for using central counterparties for derivatives and higher capital for inter-financial sector exposures.

Containing Leverage

Basel III calls for a non-risk-based leverage ratio that includes off-balance sheet exposures to complement the risk-based capital requirements. This requirement mandates banks to limit their total assets to 33 times their equity capital. The objective is to contain the system-wide build-up of leverage that triggered the 2007–2008 global financial crisis.

Other measures proposed by the Financial Stability Board (FSB) to contain systemic risks

The FSB and the BCBS have announced that globally systemically important institutions (G-sifi) would be required to hold capital surcharges and write “living wills”—plans that would enable regulators to shut them down in a crisis—by the end of 2012. These institutions will face an equity surcharge, ranging from 1 to 2.5 per cent of their assets, adjusted for risk, on top of the Basel III global minimum of 7 per cent core Tier 1 capital. The FSB consultation document set out a series of measurements that will be used to determine each bank’s surcharge, including balance sheet size, the size of cross-border claims and liabilities, its reliance on wholesale funding and the amount of lending it does to other financial institutions. Banks with big custody, payments and derivatives businesses will face higher surcharges, as will those with large trading books. In addition, governments will be expected to create special resolution laws tailored for banks. Currently, only five countries, including the United States and the United Kingdom, have them (Masters, 2011b).

The FSB also raised the possibility of moving depositors to the top of the hierarchy of bank creditors, something that currently occurs in only six countries. Such a global rule change could reduce the cost to taxpayers of bank failures, but make it harder for banks to sell bonds (Masters, 2011a).

The FSB is also working on a common data template for G-sifi banks. In a consultation paper published on October 6, 2011, the FSB suggested that such a common data template would strengthen information on financial linkages between major banks and on their exposures and funding dependencies. The proposals are designed to meet recommendations 8 and 9 of the International Monetary Fund/FSB report, *The Financial Crisis and Information Gaps*, which was endorsed by the G-20 in November 2009 (Financial Stability Board, 2011).

The Likely Implications of Basel III: What Will Be the Trade-Offs?

Whether or not Basel III will contain systemic risk and increase stability across the global financial sector is difficult to assess ex ante, and stakeholders offer widely different opinions on how it will play out. For example, in terms of banking flows, studies by the Macro Assessment Group of the Bank of International Settlements (2010) based on models covering 17 industrialized countries indicate that the average estimated increase in lending spreads is roughly 15 basis points by 2015 in response to a 1 percentage point increase in the target capital ratio over four years. However, another study undertaken by the Institute of International Finance (2010) that concentrates on the European countries, the United States and Japan indicates a two percentage point increase in the target capital ratio (reflecting both the increase in capital and liquidity standard), which results in the increase of the average lending spread by 132 basis points during 2011-15. The BCBS has extended the implementation time frame of capital ratios to 2019, which is in itself an indication of the complexities and uncertainties involved.

The main questions that face both regulators and the banking industry at this point is if the positive effects of lowered systemic risks across the banking system sufficiently compensates for the increased equity and capital costs, lower leverage and potentially, lower profitability. Unfortunately for banks, capital requirements come at a cost given that equity is significantly more expensive than debt as a source of financing. To meet the new capital requirements, banks are likely to raise new capital, issue new types of financial instruments, and repurchase or otherwise unwind financial instruments that the new rules make ineligible for purposes of regulatory capital. As such, some industry commentators are concerned that the rising demand for equity capital should increase both the price and the required return on capital, at least in the short term (Bill, Chan, Milne & Thomas, 2011). Industry sources go even further—the Institute of International Finance (2010b) estimates that the Basel III capital rules can increase borrowing costs by 3.5 per cent, lower global output by 3.5 per cent by 2015 and hence involve the loss of 7.5 million jobs worldwide. Lawmakers, on the other hand, suggest that as banks hold more capital and bank leverage declines, this will lower equity risk premiums, capital costs and funding expenses. With time, the costs of raising capital will decline and, in turn, this will reduce cost of credit costs. Lawmakers also say that societies should not be subject to the risks of a highly leveraged financial sector that is managed on short-term funding and indeed one where profits are so dependent on derivatives and proprietary trading activities. Instilling better market discipline is indeed at the core of the spirit of Basel III.

The Basel III liquidity rules are also giving rise to different concerns. To meet the new liquidity standards, banks will need to increase low-yielding liquid assets and thereby divest less liquid, higher-yielding assets. Lobbyists have been quick to point out that this will lower the earning yield of banks and hence the profitability of the sector at large. The counter-argument is that if Basel III results in a more resilient banking sector, it will reduce the need for public sector bailouts and, as such, bring down risk premiums across the banking system. Similarly, by reducing leverage in banks, both risk sensitive deposit insurance premium levels and wholesale and interbank funding costs are likely to decline (Went, 2011). Whether the collective effect of lowering these two costs would offset the potentially higher-equity capital costs and the foregone yield demanded by high-liquidity assets cannot be determined at the present time.

Basel III is also likely to bring changes to how banks will perceive and manage risk as the supervisory focus is concentrated on specific areas across a bank's asset and liability base where risk can concentrate. The augmented capital requirements are also likely to promote more efficient use of all bank capital, which will inherently include changes in the way risks are managed.

Several commentators have also pointed out that the Basel III liquidity standards will force banks to adopt risk management practices that will better measure and manage liquidity risks and include the same in managing credit and market risks. Moreover, assessing the risks of intraday liquidity positions, managing counterparty credit and bilateral exposures, particularly when trading with complex securities, will require that banks develop risk indicators that serve as early warning signals, which will provide added impetus for increased risk management across the sector (Went, 2011). The sovereign debt crisis also highlighted the need to review the definition of safe assets, which include the bonds of countries such as Greece, Portugal, Ireland and Spain. The BCBS has announced that it will fast track ongoing work on how these requirements are calculated to provide for increased market certainty.

As the sovereign debt crisis in the United States and the Eurozone increases market nervousness in these regions, Basel III is also described as being counterproductive, as banks are competing for and hoarding capital at a time when they can ill afford to do so. As the *Financial Times* reported in August 2011, "the damping effect on the return on equity of banks being forced to hold equity equivalent to as much as 10% of their risk-weighted assets is a key factor persuading

shareholders that they should be wary of owning bank stocks. When combined with the low growth economic outlook, lower dividends thanks to profits having to be retained for capital purposes, and the bear market panic over bank's short-term vulnerabilities, you have a potent cocktail" (Jenkins, 2011). It is also the case that the tight time frames that the banks have been awarded to comply with Basel III open ample opportunities for regulatory arbitrage as compliance in emerging and low-tax jurisdictions is likely to lag behind.

National regulators have not been completely oblivious to the lobbyist call for banks to appear stable at times of market uncertainty. In the French draft regulations stemming from the 4th EU Capital Requirement Directive that seeks to implement of Basel III, banks are provided with the flexibility to include the capital in their insurance businesses as a part of their overall capital requirements. This will allow French banks to maintain high capital ratios and this is giving rise to concern that other countries will similarly adopt differentiated rules to suit their national context. The end goal of the Basel rules—to provide for uniform and comparable standards across the global banking industry—is therefore compromised.

The Basel III leverage ratio is also giving rise to debate and indeed the 4th EU Capital Markets Directive appears to have reduced compliance requirements on this point. The leverage ratio requires banks to maintain their total assets to 33 times their equity, reflecting an important lesson learned from the fall of Lehman Brothers, which was leveraged 50 to 80 times their capital, making the institution vulnerable at times of large consecutive losses. Commentators are pointing out that this disadvantages low-risk, high-value financing, including trade financing. Regulators, however, point out that the value of the ratio is fundamental because, unlike capital ratios, it does not rely on banks' internal models to determine risks. As Stefan Inges, chairman of the BCBS stated in an interview with the *Financial Times*, "It is a simple blunt tool but all other rules are highly technical. Adding a leverage ratio says: suppose we don't do the model rights, this is the ultimate brake" (Masters, 2011).

Basel III and its Immediate Play-Out in Emerging Economies

Following the arguments made above, Basel III can be expected to increase lending rates and thus lower lending volumes in emerging and lower-income economies, at least in the short term. This will in turn affect both trade dynamics and financial flows. In the case of financial flows, the overall impact of lowered bank lending will depend on interest rate dynamics, the assessment and culture of "risk" in each jurisdiction and, indeed, the extent to which the jurisdiction depends on foreign bank lending. In the case of trade flows, the high bank lending rates can increase economic stagnation in industrialized countries and Brazil, Russia, India and China (BRIC), which in turn will stifle exports from lower-income nations. How well emerging economies cope in this scenario will also depend of the availability of non-bank lending and wider monetary policies. Furthermore, this phenomenon is exacerbated by the dynamics in the currency markets, a problem that does not belong to Basel III, but that may hamper its intermediate role. Its solutions may be disconnected from those of other actors (e.g., the International Monetary Fund) of the financial market.

The issue is that high lending costs and lower lending volumes will impact both direct bank-to-bank lending and bank-to-non-bank lending from industrialized to emerging economies. These effects can increase information asymmetries and differences in financial sector regulation across different jurisdictions. For example, if loans to firms in emerging countries are restricted, this could lead to a decline in investment and asset prices. As collateral is an important determinant in bank lending decisions in emerging counties, the decline in asset prices can reduce domestic bank

lending. This will, in turn, reduce direct lending from banks in industrialized economies. Emerging country bank lending will also be influenced by the degree to which other forms of financing are available, especially to small businesses that will be hard pressed to access non-bank lending.

Indeed, concerns about reduced lending to smaller businesses have surfaced from a number of commentators, as banks prepare to hold higher quality capital against loans they provide to them. As Peter Sands, chief executive of Standard Chartered, said in his interview with the *Financial Times*, “the costs of credit for those sets of customers who are at the higher end of the risk spectrum and have less alternatives will be the ones that will face the most significant changes, and unfortunately, that means segments that are very important for the economy, such as small and medium sized business and corporates” (Golf, 2011). The reality is that many emerging countries are still implementing the Basel II rules and it is unclear when Basel III will be given due attention. It is also critical to note that, similar to the two preceding Basel Accords, these international agreements between central bankers and banking regulators do not directly bind regulators or banks at the national level. So, unless there is international pressure for governments to enact legislation that incorporates these proposals into the national regulatory framework, these rules may remain without bite.

The Legacy of Basel II

When looking at how Basel III will increase stability and safety across the banking sector, it is important to realize that Basel III builds on the requirements of Basel II, and as such, the existing shortcomings of Basel II remain unchanged. Hence, concern is increasing that Basel III will further exacerbate financial and monetary imbalances between industrialized and lower-income countries. Indeed, commentators such as Joseph Stiglitz are pointing out that Basel II was, in itself, an underlying cause of the 2007–2008 global financial crisis (Blundell-Wignall & Atkinson, 2008). In the years before the financial crisis, Basel II was already being widely regarded as a blunt instrument and commentators were beginning to point out the mismatch between the actual risks of assets and the regulatory capital awarded to them. The Basel Accords influenced the emergence of a global financial system that did not recognize the need and macroeconomic circumstances of lower-income and emerging countries and the need to provide the space for financial institutions to take on the additional risks needed for economic expansion. For example, under the Basel Accords, a loan to an industrialized jurisdiction received the same capital surcharge as one made to a lower-income country, and risks involved in lending to a multinational firm were treated in the same way as a retail customer overdraft. This created perverse incentives for banks to engage in regulatory arbitrage¹ in two ways: moving toward riskier, higher yielding assets and shifting assets off the balance sheet by securitizing² them (Friends of Europe, the Foundation for European Progressive Studies, Initiative for Policy Dialogue & Financial Times, 2009).

Surveys conducted in the run-up to the 2007 credit crunch go further to demonstrate that Basel II was not living up to its three stated objectives: specify minimum capital requirements (Pillar 1), guidelines on regulatory invention to national supervisors (Pillar 2) and new information disclosure requirements with a view to increase market discipline (Pillar 3).

¹Regulatory arbitrage refers to actions taken by banks and market participants to exploit the difference between economic risk and regulatory requirements to reduce capital levels without reducing exposure to risk.

²Securitization is a way of financing a pool of assets that involves transferring them to a third party conduit such as a special service vehicle, which issues asset-backed securities that are claims against the asset pool.

Let us look at the Basel II first objective, or Pillar 1: minimum capital requirements and the advance integral ratings based (A-IRB) approach. Under these rules, banks were permitted to use their own models to estimate credit risks, and regulators believed that this would closely align regulatory capital with underlying risk, thereby reducing the incentives for arbitrage. Those without resources to operate in-house models were to adopt the “standardized approach,” which is essentially a more refined version of Basel I, which linked more sophisticated risk categories to external credit ratings provided by commercial rating agencies. The point is that the amount of capital a bank requires to be safe and stable depends on the size and riskiness of its assets, and the difference between a bank’s risk-weighted assets and its unweighted assets can vary across banks and across countries. This opens up opportunities for institutions to underestimate their risks and hence lower the capital they maintain. In early October 2011 the BCBS announced that they will conduct a formal study into this issue.

Basel II also proposed a division of approaches to securitization, but required both approaches to be based on external credit ratings. In addition, Basel II moved to regulated market risks—the risks of losses on and off-balance sheet positions arising from movements in market prices. In this area, Basel II promoted the use of mathematical modelling to produce estimates of Value at Risk,³ the probability that losses on a portfolio of financial assets will exceed a certain amount within a specified time horizon.

Evidence that Pillar 1 was not living up to these expectations was evident from the Quantitative Impact Study (QIS) conducted by the BCBS (2006) across 2004–2006, which forecasted large capital reductions relative to Basel I levels for banks employing the A-IRB approach. For example, the 2006 QIS-4 shows that these banks will face an average drop in overall capital requirements of 15.5 per cent and a median reduction in Tier 1 capital of 31 per cent. Since large banks that use the A-IRB approach hold large shares of the global market, overall capital levels in the banking system is likely to have declined and this is directly contradictory to the objectives of Basel II.

Basel II may also have contributed to rise of “too big to fail” entities, which is another contradiction to the objectives of Basel II. QIS studies of the BCBS between 2004 and 2006 indicate that large entities using the A-IRB approach made significant gains on smaller institutions in terms of capital obligations. The 2006 QIS-4, for example, shows that banks using A-IRB was expected to reduce capital by up to 26.7 per cent, while banks using the standardized approach was forecasted to expect an increase in capital requirements by 1.7 per cent (BCBS, 2006). In other words, the larger banks (using A-IRB) were able to free up capital and expand their assets while smaller banks (who do not have the resources to use A-IRB) would need to plan for deleveraging. This would certainly affect the profitability of smaller banks; in fact, “a 2006 survey of 300 banks by Ernst & Young had found that 75 per cent [of respondents] believed Basel II would benefit the largest banks, employing the most advanced risk modelling systems, at the expense of those unable to adopt them” (Kurian, 2012).

Commentators have also pointed out that Basel II fell short by not addressing trading book risks, which has greatly increased in significance after Basel I. Equally concerning was that A-IRB banks were given the freedom to use their own estimates of the risk parameters for unrated exposures and liquidity facilities in the area of asset back securitization. Basel II also stipulates low levels of capital for highly rated securitization tranches—the same tranches that incurred large losses in the subprime mortgage crisis (Masters, Sander & McCrum, 2011). To address these concerns, the Bank of

³ Value at Risk is calculated based on the probability that losses on a portfolio of financial assets will exceed a certain amount within a specified time horizon.

International Settlements plans to conduct expert reviews, learning from the experience of the International Monetary Fund. The reviews will focus on assessing and comparing methodologies used in different countries and by different banks to calculate risks of similar assets.

The Emergence of the Shadow Banking Sector

Basel III may also be adding momentum to the rise of the shadow banking system. Hedge funds, buy-out firms, unregulated investment funds and insurance companies are all providers of credit and transactions services provided by banks, but are not included under Basel III. There are very important signs to indicate that they have been fast in spotting the opportunity to step in. Acting as “shadow banks,” these entities are free to use their investors’ money and seek wholesale funding to engage in direct lending and other banking services without being subject to Basel III rules on capital and liquidity. Shadow banks are also reportedly targeting smaller businesses that “are too large to visit their local bank but too small to attract the attention of the bond market” (Masters, Sander & McCrum, 2011).

While several jurisdictions, including the European Union and a few other countries, have passed regulations to increase microprudential frameworks and reporting requirements of these entities, regulators are likely to remain in the dark on their leverage, risk managements practices, liquidity levels and more. It is not too early to question if these entities, would in the future, be the catalysts of the next global financial crisis.

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