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10Questions:
UPDATE ON BASEL III

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FW speaks with Dwight Smith, a partner at Morrison & Foerster LLP, about the third instalment of the Basel Accords.

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Dwight Smith is a partner at Morrison & Foerster LLP. He focuses his practice on bank regulatory matters that affect the full range of the operations of banks and thrifts. Mr Smith's recent representations have covered new requirements for banking institutions under the Dodd-Frank Act and Basel III, bank mergers and acquisitions, efforts to raise capital, and formal administrative enforcement proceedings. He has written or spoken on a variety of banking issues, including bank capital, compliance issues and privacy and data security. Mr Smith can be contacted on +1 202 887 1562 or by email: dsmith@mofo.com.

FW: Could you provide a broad overview of the key objectives envisaged by Basel III, and the reasons behind its introduction?

Smith: Basel III has two key objectives. First, the standards in Basel III are the principal international response to the financial crisis that began in August 2007. The Basel Committee, the author of the new rules, is attempting to prevent a recurrence of the crisis, or at least to mitigate the effects of the next one. Accordingly, the new rules emphasise the importance of common stock by creating a new higher tier of capital know as common equity tier 1 capital (CET1), strengthen capital requirements, and place higher capital charges on certain risky assets. Basel III also introduces new requirements, including a leverage ratio and two measurements of adequate liquidity. Second, Basel III shares the objective of earlier versions of the Basel capital standards: ensuring international consistency of capital standards and levelling the playing field across jurisdictions. To that end, the Basel Committee has issued extensive guidance for national regulators on what constitutes adequate supervisory and capital regimes and has begun in earnest to review national compliance with Basel III.

FW: Which particular asset classes are affected by the rules? What impact will these rules have on derivatives, 'repo-style' transactions, collateral and guarantees, and securitisations, for example?

Smith: Nearly all asset classes are affected to some degree by new Basel rules. The prices of financing and related instruments, even if they primarily serve a hedging function, may fall, since these instruments must carry greater amounts of capital. The increase in capital is the result of the new requirement that the full amount of off-balance sheet exposures be converted in full to an on-balance sheet asset for capital purposes. Other changes may affect the cost of these instruments as well. With respect to derivatives, for example, the rules impose more rigorous criteria for recognising netting agreements. The credit risk mitigating effect of collateral is now determined through a complex calculation that requires several different haircuts. Guarantees represent an unusual approach: the universe of eligible guarantors has been expanded, rather than contracted, but there are new requirements to ensure the enforceability of a guarantee. As to securitisations, Basel 2.5 imposes generally higher capital requirements, including increased capital charges on liquidity facilities. Banks that purchase asset-backed securities must be able to demonstrate to their regulators that they have a sophisticated understanding of the risks involved.

FW: How have countries begun to implement Basel III-type requirements, even though formal rulemaking has not been completed?

Smith: Outside of the formal process for implementing Basel III through statute or regulation, national supervisors have begun to apply new capital requirements in two ways. First, even before the basic Basel III document had been completed, most national regulators had imposed higher capital requirements on their systemically important banks. These requirements varied on an institution-by-institution basis but anticipate the new capital ratios, leverage ratio, and liquidity requirements in Basel III. Second, stress testing and the assessment of capital adequacy, another series of events that predates Basel III, have incorporated capital requirements much like those in Basel III. In the US, for example, systemically important institutions were required to raise capital levels on the order of those in Basel III. In the testing process, all jurisdictions have recognised the importance of common stock or common equity in bank capital—a fundamental element of Basel III.

FW: What is the current status of European rulemaking?

Smith: The formal implementation date for Basel III is 1 January 2013. The European Union (EU) seems unlikely to meet this deadline. Basel III is embodied in Capital Requirements Directive IV, known as CRD IV. CRD IV is now pending in the European Parliament . On at least two occasions, the European Parliament has delayed action on the measure, while the EU has attempted to iron out differences on CRD IV, among them the new liquidity requirements. Action by the European Parliament now is scheduled for 21 November 2012. Keep in mind, even once approved, CRD IV will have the force of law only after publication in the Official Journal of the European Union, a potentially lengthy process.

FW: How closely are European countries adhering to Basel III?

Smith: During 2012, the Basel Committee undertook in-depth reviews of Basel III implementation on a jurisdiction-by-jurisdiction basis. The review of the EU was preliminary because CRD IV has not been finalised, but the review contained several concerns, including two components of CRD IV that were "materially non-compliant." First, the EU proposal would permit banks to choose between Basel III and the Basel II standardised approach when risk-weighting assets, and to do so on an asset-by-asset basis, an approach rejected by Basel III. Second, with respect to the composition of CET1, the EU proposal appears to give undue latitude to banks. Under the proposal EU banks may include instruments in CET1 that may differ from common stock, as well as granting greater authority to mutual or co-operative institutions to include redeemable stock in CET1. The EU proposal also does not require the same level of deductions from CET1 as do the Basel III standards. The EU allows banks to include a greater amount of minority interests in Tier 1 capital, provides for a hedging offset for the deduction of unrealised gains and losses resulting from changes in a bank's own credit standing (an offset wholly absent from Basel III), enables banks to include holdings in other financial institutions in CET1, and treats investments in insurance entities more liberally than does Basel III. Some EU members have taken a harder line than does CRD IV. The UK Financial Services Authority (FSA) has told its institutions to expect Basel III-type standards and, even before Basel III takes effect, to build loss-absorbing capital to levels higher than those required by Basel III and to restrain cash dividends and compensation.

FW: What is the current status of United States rulemaking?

Smith: In June 2012, the US federal bank regulators proposed three sets of Basel-based capital rules that will affect all US banks regardless of size, referred to in shorthand as the Basel III, Standardized Approach, and Market Risk Proposals. The comment period for the industry ended on 22 October 2012, although small banks will have an opportunity to weigh in on impact issues until at least 16 November. This schedule will not permit the US regulators to finish their version of Basel III by 1 January 2013. We expect, however, that the rules will be completed during the first quarter of 2013. The proposed rules generally match Basel III requirements, but whether the final rules will do so is uncertain. The Basel III process has now entered the political realm as senators and congressmen have begun to weigh in. Among other industry responses to the proposed rules, smaller banks have objected to the effort to push Basel III down to them. Any changes on this issue would not affect the requirements for systemically important US banks, but the effort to address this objection may slow finalisation of the proposals.

FW: How closely is the US adhering to Basel III? Are there any specific departures from Basel III, including those affected by US statutory requirements?

Smith: The US has attempted to hew fairly closely to Basel III. In the Basel Committee's review of Basel III compliance, the group noted fewer differences than it did with respect to the EU proposal. The one materially non-compliant feature that the Basel group found was the risk-weighting of securitisation exposures. Basel III continues the practice under earlier Basel standards of reliance on external ratings. The Dodd-Frank Act prohibits the use of external ratings, and the US proposal accordingly risk-weights on the basis of the risk weights of the underlying assets adjusted for quality. In the Basel Committee's view, the US approach could result in lower capital charges for US banks than for non-US banks holding identical exposures. The reviewing panel also expressed concern about other "largely compliant" elements of the proposed rules, including: more liberal treatment of investments in insurance subsidiaries; potentially unduly advantageous treatment of US sovereign debt and the debt of Fannie Mae and Freddie Mac; certain provisions for the internal ratings-based approach under Basel II; counterparty credit risk; and certain differences in operational risk standards.

FW: Looking specifically at liquidity rules, what impact will Basel III have on the market?

Smith: The impact of the liquidity rules is likely to be increased uncertainty and volatility in the sovereign and corporate finance markets. These effects may not be felt immediately, however, since the liquidity rules are still under discussion. Basel III presents two liquidity requirements that are new to the Basel capital process, and each one presents an important issue for the market. First, the 'Liquidity Coverage Ratio' requires a bank to hold "unencumbered, high-quality liquid assets" in amounts sufficient, under an acute stress scenario, to meet the bank's monetary obligations over the coming 30 days. High-quality assets consist primarily of sovereign and bank debt. Historically, such debt has been liquid on a continuous basis and can be valued without difficulty. The past few years have revealed a much different picture. As a result, Basel III may result in greater uncertainty about liquidity even in these markets, a development likely to be amplified by the stress testing. Second, the 'Net Stable Funding Ratio' requires a bank to maintain stable sources of funding relative to the liquidity of the bank's assets and to the bank's off-balance sheet commitments over a one-year time horizon. The Basel Committee was explicit that this measurement is intended to discourage reliance on short-term wholesale funding. If the Basel Committee is successful, it will be because the ratio has disrupted the short-term wholesale funding markets.

FW: What advice would you give to banks on gearing up for compliance with Basel III? What essential steps do they need to take?

Smith: Basel III will require a bank to re-visit its entire capital and liquidity planning process – a task that has already begun at many banks. Three steps are important. First, a bank must review – and should expect to enhance – its information-gathering systems, since Basel III requires a greater amount of information and analysis than have earlier Basel standards. Second, a bank should adopt a longer time horizon in its capital planning. The new Basel III provisions phase in and take effect over several years but not necessarily in a consistent manner. For example, changes to the numerator of the capital ratios will phase in from 2013 to at least 2018, but the changes in the denominator, the risk-weighted assets, take effect all at once, in 2015. Third, banks should begin to review their levels and types of both capital and funding under the new rules, even before all of the requirements take effect. Basel III's more complicated approach to capital and liquidity could require changes more frequently and in greater amounts than has been the case in the past.

FW: In what ways do you expect Basel III to shape the world's banking and finance markets? Will the new rules achieve their intended aims?

Smith: Basel III should achieve the two objectives previously mentioned – growth in the amounts and quality of capital so as to prevent a future crisis, and greater international uniformity – but perhaps only on a relatively near-term basis. First, Basel III will support the enhanced capital requirements that national regulators already have begun to apply. Second, the Basel Committee has actively promoted a level playing field for banks in all countries. Full standardisation will be impossible – for example, the US statutory prohibition on the use of external credit ratings – but a greater degree of uniformity may well be achieved. Over the long run, however, Basel III will not be a panacea. The new standards will dampen the capital markets for most instruments other than common stock or covered bonds. Further, the more stringent capital requirements are unlikely to prevent or even to mitigate the next banking crisis. It could even be the source of the next crisis in ways that we cannot anticipate. The lenient Basel I risk-weights on home mortgage loans unduly encouraged such lending and helped, if unintentionally, to spur the financial crisis. ■

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