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Towards a New Basel Accord with More Rigorous Settlements

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Abstract. *The recent financial crisis made the banking sector more vulnerable to shocks. The system was characterised by weaknesses: too much leverage in the banking; not enough high quality capital to absorb losses and excessive credit growth based on underwriting standards and under pricing of liquidity.*

This article is about a new accord Basel III and the view of this framework. Basel III will be finalized before November 2010, and will be implemented by the end of 2012. Basel III is going to be implemented in the United States. All G–20 countries should adopt progressively this capital framework. The Basel Committee on Banking Supervision and national authorities should develop and agree a global framework for promoting a stronger liquidity in financial institutions. The reform program is to raise the resilience of the banking sector through promoting more sustainable growth, both in the near term and over the long therm.

The initiatives of Basel Committee will develop a set of reforms based on four steps: public consultation, impact assessment, overall calibration and macroeconomic impact assessment over the transition period.

Keywords: BCBS reforms; capital distributions; minimum capital requirements; additional capital; systemic risk; externality; procyclicality; risk exposures; financial stability; leverage ratio.

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World economy is currently experiencing a period of slight recovery after the financial crisis which has involved all the sectors of economic life, due to which we ask ourselves, more than often, questions like: “What should we expect?”, or “What will happen next, economically speaking?”.

This economic crisis has strongly affected the American banking system, then spred on the European banks, which has led to the appearance of some international settlements in the field of ensuring the financial security, settlements regarding a new agreement in the banking field.

Whether the Basel I and II Accords, through the requirements issued, have contributed to a better capitalization of banks, currently there has been the need of new prudential policies, more complex which have led to the decision to make an accord, that is the Basel III Accord. This is stipulated („Financiarul, 2009) to be finished, according to the Basel Committee, before November 2010 and for the implementation period it is mentioned the end of 2012.

The new elements brought into discussion, regarding a new accord, have been the object of numerous meetings of the G–20 member countries, on the subject of new banking settlements.

The London G–20 group agrees on a new Basel III Accord and it considers that it should be finished by 2011 so that it could be implemented as soon as possible.

In December 2009, the Basel Committee on Banking Supervision published, in this view, two consultative documents, entitled: “The Consolidation of the Resistance of the Banking Sector”, a document which has been mentioned in the press and also on the Internet, with the title “Basel III”, and a second document: “The International Frame to Measure the Liquidity Risk, the Standards and Monitoring”. These are part of the Basel Committee’s activity, but they are just projects and do not represent a legal frame for a new accord.

There have been and still are different opinions and preoccupations in this view both of the European banks and of the American banks. The Europeans consider that Basel III will be implemented more rapidly at the European level, and it what the USA is concerned, this thing will take place subsequently and its measures have been initially considered as an optional guide of settlements.

Internationally (“Financial News”, 2010), the novelties brought by this new accord will have a major impact on the banking sector, on the loan offer and on the problems regarding the economic development. The requirements mentioned in the new accord will have to determine the banks to have more liquidity, of a higher quality, as short term coverage.

At the G–20 London Summit[1], in April 2009, problems regarding the coarsen of the rules to reform the financial sector were brought into discussion and it was predicted that all the members present at this meeting should progressively adopt the frame of settlements and the Basel Committee on Banking Supervision and the national authorities should develop and agree on a new global frame meant to solve the problems concerning a stronger liquidity at the level of financial institutions, including here also the transborder financial institutions.

At Pittsburgh, in September 2009, the G-20 Summit drew up a report regarding the actions to promote the financial settlements established, according to which the global standards should be implemented constantly so that they ensure “a permitted and authorised level of market fragmentation, protection and rule arbitration[2]”. In their opinion, progress can be achieved with the help of the Decision Group of the transborder banks, of the Basel Committee on Banking Supervision and the World Bank, which establish recommendations for the authorities regarding the problem of crisis management and decision making process.

Another problem brought into attention was that regarding the introduction of a frame in order to cover the countercyclical capital, before the settlement requirements. This frame will include measures to keep the capital and also constraints regarding the capital distribution.

What the Basel Committee has in view is also the setting up of some standards regarding the establishment of long term provisions, based on the losses forecast. It is also necessary a very detailed economic analysis so that the requirements which are going to be established can be finished in due time. The analysis will follow the improvement, both quantitatively and qualitatively, of the banking capital as well as the discouraging of some activities taking place excessively and which could hinder the recovery of economy.

Nationally, the implementation of a high level and of a better quality of the settled capital, of the elements of the Basel II Accord, as well as of the requirements to improve the liquidity risk and also of the long term provisioning activity will determine the banks to give up taking an excessive risk. These measures will try to create a much better prepared financial system to cope with the possible economic shocks that might occur. Due to this it is necessary a fair evaluation of capital and the encouragement of the additional capital increase. The banks are advised to retain a higher percentage from the current profit in order to raise the capital. This capital must support the loans given.

Therefore, in this period of crisis an important objective would be to combine the measures regarding the risk cover, according to the Basel II Accord, with the measures regarding the improvement of the capital quality and the increase of the global minimum requirements.

An important step for the settlements to come, through this accord, Basel III, is to study the official documents, for example BIS[(3)] Working Papers, no. 309, regarding the global risk, where Stephen G. Cecchetti, Ingo Fender and Patrick McGuire, from the Economic and Monetary Department, provide a definition of the systemic risk: "the systemic risk in the financial system is similar to pollution", that is an individual institution can impose on others, through its actions, the same things. This phenomenon, considered as an externality, can have two forms, that is:

- it is considered the common failure of several institutions, as starting from something individual, particular, resulting in a common presentation both outside the financial system and the connection between intermediaries;
- the second meaning of externality refers to procyclicity. The procyclic systemic risk refers to the progressive building of the financial frailty and also to the increase of the risk of economic collapse. The systemic risk may occur in the financial-banking system also due to some new financial products which may be introduced on the market, their effect being harder to be foreseen. The financial institutions become less prudent during the cyclical increase period and more prudent during the decrease periods. During the stable, homogeneous periods, the volatility of the economic markets has the tendency to be lower and the risk is compressed.

All these problems regarding the appearance of the crisis, the increase of the risks in the banking institutions have determined the reviewing process of the Capital Adequacy Directive[(4)].

The secretary of the Basel Committee on problems regarding the banking supervision, Stefan Walter, stated that the main objective of the Basel Committee was in this period to increase the elasticity of the banking sector, promoting a more sustainable development both on short-term and on long-term. Also, in the Basel Committee's agenda there are norms to stabilize the real economy for it has been considered that the period before the crisis generated weaknesses in the banking system, weaknesses determined by:

- too much lightness in banks and in the financial system, but weak quality of capital to absorb the losses;

- excessive increase of the loan and the insufficient coverage with liquidity;
- incorrect, inadequate support in banks which was based on an inherent procyclicity of the financial markets and the participants to it;
- too much systemic risk, a weak interconnection between the financial players, the common exhibition to shocks, all these leading to the increase of the problems concerning bankruptcy.

Due to the problems concerning the economic crisis (Cinteză, 2010), its harshness, by the fact that this crisis penetrated with too much lightness the financial system, it has been required as being necessary a reform programme of the Basel Committee on Bank Supervision.

The key elements of the reform programme of the Basel Committee on problems concerning Bank Supervision (BCBS)

The reforms of the Basel Committee have objectives making the connection between the analysis performed by this committee and the short-term results. The elements had in view through the reform programme refer to:

- the ensurance that a high qualification of capital can absorb possible losses occurred by exposure to risks;
- the ensurance that all the material risks have been appropriately integrated from the inside and have been calculated through the level of settled capital;
- the introduction in banks of some supplementary verifications both for the banking supervision and for making the risk management activity more efficient. Therefore, a special attention will be paid to the three pillars of the Basel II Accord, as well as to a new instrument of capital adequacy: the lever effect;
- the establishment of some long-term provisions and the cover of countercyclical capital, thus contributing to the increase of the banking system's capacity to absorb the shocks, when they become unavoidable;
- the introduction of some minimum global standards to measure and control the liquidity risk;
- the strengthening of the banking system through rules and its systematic supervision, thus forcing the internalization of risks;

- the improvement of the risk management activity as well as of the risk governance, set up through the supervision process in pillar II of the Basel II Accord;
- the increase of the market discipline by intensifying the transparency in accordance with Pillar III of the Basel II Accord and the capital adequacy;
- the promotion of some more practical approaches leading to the management consolidation of the banks outside Basel.

All these new reforms are considered much stronger for the banking system. The safer the financial system, the more it will lead to an economic development, to long-term intensification and welfare, concomitantly with the minimization of economic costs on short-term.

The impact of these reforms being implemented

With the help of these reforms, banks should return to the level of profitability before the crisis. The profits obtained in this period will be used to build capital, to cover with liquidity and less to obtain dividends and other extra bonuses.

Internationally, The Basel Committee has suggested through these reforms the harmonization of some minimum liquidity standards which should ensure the banks stability for one month period during stressful times and promote a long-term elasticity of banks.

The reforms concerning the capital and liquidity have been the subject of numerous rigorous public consultations. All the comments on this subject and the consequences of these reforms being applied have been discussed. Therefore, the Basel Committee is performing a complete, quantitative research in order to evaluate a possible impact that this package of reforms will have both at the level of each bank and at the level of the entire banking system. The research will contain information concerning the capital requirements, a minimum set of measures which will be applied to banks, countries, business models.

Also, the cumulated impact of these reforms will be studied so that to ensure in the same time certain prudence on long-term concerning the availability of loans. In critical situations, these reforms should follow the banking compensation and support on long-term. The Basel Committee has in view that the implementation of reforms as well as the transition procedures to the new standards do not compromise the possible short-term economic development.

All these economic reforms are oriented towards future, making the financial-banking system more flexible to possible future economic crises. Even though some countries and banks have not caused the current economic crises, the entire world is affected by this crisis. The economic crisis has affected not only all the world regions, but also all the types of products, all the types of models and the evaluation levels on classes: retail, corporate, securitizations, subscriptions, credits, etc. The source of a future economic crisis cannot be foreseen, that is why this Basel Committee is the one which through the economic reform measures issued will help mitigating or reducing the impact of a possible crisis. It is essential that all the countries and banks contribute to the strengthening of the banking system.

The lever effect – as a supplementary indicator of capital adequacy, according to Basel III

If until now the prudential settlements of capital adequacy had in view heated discussions between the regulating authorities of the banking system and the commercial banks regarding the subject of liquidity and provisions, this indicator “the lever effect” will be introduced in order to avoid the excessive indebtedness of banks.

For this new indicator there is no standard for the existing differences between the accounting systems make more difficult to measure and compare a possible level of it.

In order to establish a common level for the lever effect, the approaches are different: in the USA the minimum level required for this indicator is of 3% for the commercial banks and of 4% for the rest of the banks, although, in the present, they speak[(5)] about an existing level of over 5.5% which is considered appropriate. According to the same source (Newspaper “Financiarul”, may 2010), in Austria this indicator must be of over 6%. Canada takes into account when computing this indicator the risk weighted assets and Switzerland is one of the countries where in the computation of the lever effect they take into consideration the adjusted asset value (according to the portfolio of loans given to the residents). The necessary minimum considered appropriate is of 3% at the consolidated level and of 4% at the individual level.

In our country, this indicator is used by the National Bank of Romania for analysis. The lever effect is computed as a ratio between the level I equity ownership and the balance sheet assets.

$$\underset{(\text{rate of equity ownership})}{\text{The lever effect}} = \frac{\text{Level I equity ownership}}{\text{Average value balance sheet assets}}$$

The main component of the level I equity ownership is represented by the equity ownership and the average value balance sheet assets are those assets resulting from adding the value of all the assets at the end of the month and dividing this result to the number of months taken into consideration.

The calculus formula of this indicator can be also written like this:

$$\underset{(\text{rate of equity ownership})}{\text{Rcp}} = \frac{\text{Equity ownership}}{\text{Total asset (net value)}}$$

The Supervision Directorate within the National Bank of Romania implemented a Homogeneous Bank Rating System CAAMPL – with the help of which it has been tried the promotion of an efficient supervision of the Romanian banking system in order to prevent the systemic risk. This system has six specific components of analysis: capital adequacy (C), shareholders' quality (A), assets' quality (A), management (M), profitability (P), liquidity (L). All these components contribute to setting up the banking rating, to the establishment of the banks' risk profile, of the development strategy. Within the first component of analysis – the capital adequacy, belongs the lever effect or the rate of equity ownership. The indicator is computed monthly and as variation limits of the indicator the following are taken into consideration:

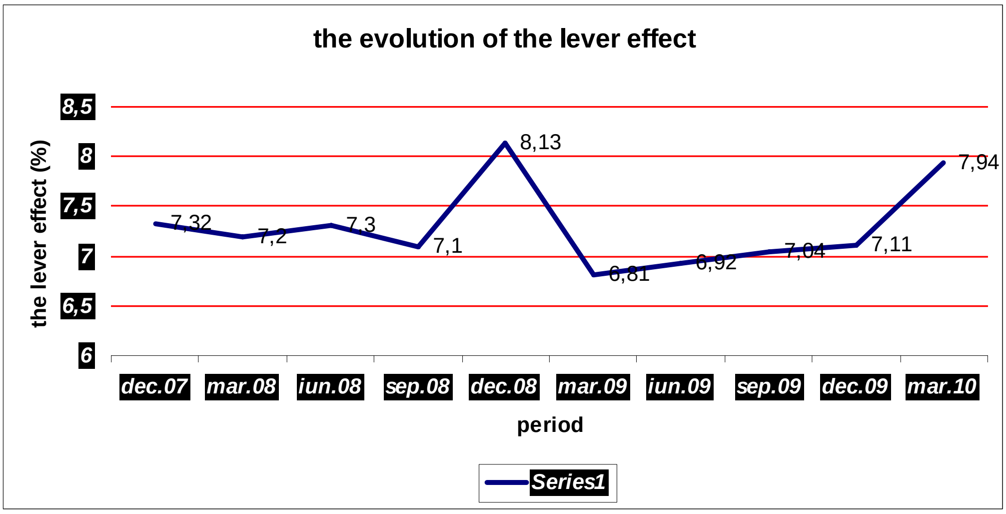
≥ 6%	well capitalised bank	rating 1
4 - 5,9%	adequately capitalized	rating 2
3 - 3,9%	sub-capitalized	rating 3
2 – 2,9%	significantly sub-capitalized	rating 4
< 2%	major sub-capitalized	rating 5

Source: The National Bank of Romania.

The determination of the elements in the calculus formula is based on the National Bank of Romania Norm no. 11 of 15.12.2003 regarding the individual and consolidated based supervision of equity ownership, published in the Official Journal of Romania no. 17 of 09.01.2004. The lever effect, as indicator, is contained at the banking level in the Calculus and Reporting Form of Equity Ownership and in the Patrimony Statement.

Currently, the National Bank of Romania accepts a minimum level set at 4%. The lever effect can be used as a supplementary measure at the banking level, so that the banks should not be excessively indebted. This, combined with the capital adequacy according to the risk, will lead to a limitation of the excessive increase of the balance sheets, both at the level of each bank and at the level of the entire banking system.

Due to the analysis performed by the National Bank of Romania at the end of 2009, it was noticed that the majority of banks in Romania were much above the admitted minimum level of 4 %, as it can be seen in the following graph:



Source: The National Bank of Romania.

Figure 1. *The evolution of the lever effect*

Only one bank in the system had a level below 4% of the lever effect due to some low quality assets, due to an inadequate capitalization of the risk associated to the assets and a high balance sheet for the capital that it had, too. There have been measures to stabilise this indicator according to the National Bank of Romania's regulations: it took place an increase of the company capital, which determined that in March 2010 the evolution of the lever effect to be above the minimum level accepted.

The introduction of this indicator has produced changes at the level of each bank, meaning that the size of the bank cannot increase above a certain limit, taken into consideration by the National Bank of Romania. Also, it will be taken into account the complexity of some banks, that is the banks presenting a too high balance sheet as compared to the capital they have will have to take measures so that the increase of the assets be limited and the profit obtained be capitalized. Also, the credit activity must be limited according to the level of this indicator, which will influence the economic development. What we can say that it is specific to the Romanian banking system is the fact that the banks do not have a high complexity level. The level of this indicator is, currently, much higher than the minimum established, even compared to other countries.

The reason for which the Basel Committee intends to introduce this indicator, as a supplementary indicator of capital adequacy, is also due to the G–20 leaders, which consider that the lever effect is "simple, transparent, and comparable at the international level".

The lever effect produces a series of advantages and disadvantages at the banking system level.

A banking capitalization according to the risk level, as it is stipulated through the Basel Accord I and II, encourages the displays with a lower degree of risk, thus resulting in a tendency to concentrate on those assets that can attract smaller capital requirements.

The banks could accumulate a higher volume of assets from other funding sources, too. This could have consequences such as a high level of assets, with a low degree of risk, high assets, but also higher indebtedness. All these have determined that through the introduction of the lever effect the volume of the balance sheet be limited.

The introduction of the lever effect can determine the reduction of some pressures from banks for the latter, through their own inside risk evaluation models, applied in banks, can represent a decision factor and can subjectively influence the regulating and supervising authorities.

A disadvantage of the lever effect is that there is no yet a unanimously international accepted definition which means that the appearance of several calculus variants could be in favour of some banks.

Not even in what the accounting system is concerned there is no perfect compatibility, because the new accounting standards have not been implemented yet and this could cause problems when comparing the indicators.

As a conclusion, we can say that an important measure of the Basel Committee is the establishment of a unanimously accepted calculus formula of the lever effect for as correct as possible analysis of this indicator is needed.

The regulating authorities wish an analysis and a concentration of the banking activity, based more on the volume of assets which will represent an important change for the big and more complex banks. This will lead to a certain maximum limit from the point of view of bank's size and dimension, that is there will not be very big banks monopolising the banking activity, as the Lehman Brothers Bank did.

If this indicator were used for a limited number of states, it would determine the establishment of a different treatment between the banks in these states and the banks in the transborder banking system.

Even if this supplementary indicator is introduced in order to try to create a more stable state in the banking system, the new banking settlements cannot exclude the occurrence in the future of some problems of different nature, which could lead to a new economic crisis.

Notes

(1) Newspaper "Financiarul" – "Şefii de stat şi de guvern din G8 şi G20 vor adopta măsuri pentru prevenirea altei crize financiare", 25 June 2010.

(2) Basel Committee on problems concerning Bank Supervision (BCBS).

(3) BIS – Bank for International Settlements with headquarters in Basel, Switzerland.

(4) CAD III – Capital Adequacy Directive – European directive which takes over the Consolidated Banking Directive 2000/12/EEC and the Directive of Capital Adequacy for the Investment Companies and Credit Institutions 93/6/EEC.

(5) Newspaper "Financiarul" – "Cu un efect de pârghie de aproape 8%, băncile au un capital adecvat şi nu sunt îndatorate excesiv", 28 May 2010.

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