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# Bankers

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is good to have,  
but risk culture  
and training  
will help avert the  
next banking crisis



2014

2015

2016

2017



# BASEL III

*Salient Features for  
the Layman*

By: Jhangeer Hanif

The best thing about any crisis is that it makes you learn. Experiencing crisis does have some incidental benefits, which, if tapped rightly, take us a step ahead from where we were. This is what Basel III is about.





**T**he global financial meltdown which emanated from the downfall of subprime mortgage in the US led the Basel Committee on Banking Supervision to take a fresh perspective on the resilience of the banking institutions around the world. The meltdown signified that the banks were not adequately capitalized in order to absorb losses and also the quality of capital was of not at the desirable level. At the same time, banks were not holding sufficient liquidity cushions. The result was the severe pressure on the financial system, the spillover effect of which was felt in the real economy. The objective of

Basel III is to augment the banking institutions' ability to combat shocks, which may arise from financial and economic stress; thus limiting the risk of collateral damage to the real economy.

Although Basel III introduces a more comprehensive framework to strengthen the regulation, supervision and risk management of the banking institutions, the punch-line is Adequacy and Quality of the capital. It is here where it would make a major difference on a global scale

through its ever stricter requirements. However, the timeline for implementing Basel III stipulations varies, culminating in 2019. Before we analyze the implications of Basel III for the banking system, it seems imperative to take a bird's eye-view of the changes introduced by Basel III. The salient features of the code are as follows:

### Capital

The Total Capital Requirement has been raised from the current 8% to 10.5%-

existing 2% to 4.5% and total Tier I from 4% to 6%. Tier II capital, the gone-concern capital, comprises instruments that are subordinated, and has a minimum original maturity of at least five years. Both Tier I and II can be 8%, which essentially means that the benefit of Tier II cannot be higher than 2% (it used to be 4% previously). Tier III capital has been eliminated. In addition to CET-I, the banks would be required to maintain two buffers (i) Capital conservation Buffer (CB) and (ii) Counter Cyclical Buffer (CCB). Banks would be required

**“DURING THE CRISIS, BANKS DESPITE SHOWING STRONG RISK-BASED CAPITAL RATIOS HAD BUILT EXCESSIVE ON AND OFF-BALANCE SHEET LEVERAGE”**

13% for the larger universe of banks. The capital is defined as (i) Going-concern Capital and (ii) Gone-Concern Capital. The going-concern capital comprises Common Equity Tier I capital (CET-I) and Additional Tier I. The first predominantly consists of common shares, share premium, and retained earnings. Additional Tier I capital refers to such instruments which have been issued for perpetuity without any maturity and are subordinate to bank's obligations. The code seeks to enhance Tier I capital from

to build 2.5% in CB over and above 4% of CET-I. This would be done in non-stress periods so that the balance can be utilized when stress befalls. The CCB will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses. This buffer would be required on need basis and its range may be from 0 to 2.5% (resultantly, the total maximum CET-1: 9%, total Tier 1: 11%). Meanwhile, a further capital cushion (1%-2.5%) has been proposed in addition to CET-1, which would be required from systemically important financial institutions (SIFIs). The premise is that SIFIs, as mainstay of economic stability, should have more resilience and strength than normal institutions to manage stress periods. At max, for SIFIs, CAR would go up to 15.5 %.

Comparation of Basel II and Basel III Requirements	Basel II	Basel III
Total Capital Requirement	8%	10.5%- 13%
Common Equity Tier I Capital (CET-I)	2%	4.5%
Total Tier I	4%	6%
Tier I + Tier II	8%	8%
	Tier II ≤ 4%	Tier II ≤ 2%



## Leverage

The code prescribes that banks should observe an overall leverage ratio. During the crisis, banks despite showing strong risk-based capital ratios had built excessive on and off-balance sheet leverage. The crisis pushed the banks to reduce leveraging, creating immense pressure on asset prices. The code stipulates that, on a test basis, a minimum 3% of Tier I leverage ratio, would be observed over a period of four years beginning Jan 01, 2013.

## Liquidity

Among other sound liquidity management and supervisory matters, a Liquidity Coverage Ratio (LCR) and Net stable Funding Ratios (NSFR) have been introduced. LCR would require banks to

Requirement of Buffers as per Basel III	
Capital Conservation Buffer (CB)	2.50%
Counter Cyclical Buffer (CCB)	0 %- 2.5%
CET-I including CB and CCB – at max	9.5%
Total Tier I	11%
Tier II	2%
Max Capital for SIFIs	15.5%

risk-weighted assets and reducing its overall leverage. NSFR would push banks towards building a long term fund base, again necessitating dilution in the spread due to associated cost of funding. Fitch estimates that G-SIFIs are likely to experience a 20% decline in RoE because of Basel III. Leveraging and Capital Requirements equally imply that there would be restraint on the banks to grow their portfolio of finances and invest-

around 50% of the banks' deposits – a ratio which was only 20% in Mar 2009. Reducing this abnormal percentage to 20% would mean to release an amount of PKR 2,000bln. If this amount is deployed equally in A and AA category finances (taking a more optimistic picture), this would give rise to PKR 700bln of risk weighted assets, which would shave off 2% from the current CAR. This entails that Tier I CAR would come down to

## “THE INDUSTRY IS NOT CARRYING ANY SIGNIFICANT CUSHION, WHICH IT HAS BEEN MAINTAINING WITH REFERENCE TO THE INTERNATIONAL REQUIREMENT HISTORICALLY”

have sufficient high quality liquid assets to withstand a 30-day stressed funding scenario that is prescribed by the regulator. NSFR seeks to ensure that banks have enough liquid resources over one-year horizon to cover the expected funding needs over the same period.

Evidently, the more pronounced requirement is the capital and adequacy of capital. The question is how the banks would be able to meet this requirement. Fitch has lately published a study covering 29 Global Systemically Important Financial Institutions (G-SIFIs). As of Dec 2011, these G-SIFIs might need to raise USD 566bln in order to meet Basel III capital rules. The sheer amount of capital to be raised is going to be a daunting task. This is especially true because investors would be aware that banking as a sector would compromise on return by balancing its portfolio in terms of

ments. One of the major considerations in the regulators' sight is also the impact that Basel III would have on credit availability. This may induce the retail bond market to expand at a faster pace, given constrained liquidity in the banking system.

When we talk about Pakistan, we find that the domestic banking sector boasts a Capital Adequacy Ratio (CAR) of 15.5% as of Mar 31, 2012. This CAR is predominantly supported by Tier 1 capital (13.3%). This demonstrates that the sector is well-positioned to comply with the code. There are certain individual institutions which may find it difficult to comply (5 banks are under 10% CAR). However, when we analyze the balance sheet of the sector, we see that there has been a build-up of government securities post 2008 crisis. Currently, government securities are

approx. 11%. This percentage is exactly what is required from non-SIFIs under Basel III. This means that the industry is not carrying any significant cushion, which it has been maintaining with reference to the international requirement historically. At the same time, any imbalance in the finances portfolio may further deteriorate this ratio. The big question mark is about those banks which are finding it difficult to comply with existing requirements. This highlights the criticality of thinking through the implementation of Basel III; how it would be rolled out and what limits should be in place for SIFIs and non-SIFIs in the domestic market. The State Bank of Pakistan, while expressing satisfaction with the resilience of the overall banking sector, is evaluating transitional path that the domestic sector would have to take in order to remain aligned with the international best practices.