**Doniyar Saidov**

**(Tashkent, Uzbekistan)**

**BASEL III: ISSUES AND IMPLICATIONS**

On 16 December 2010, the Basel Committee on Banking Supervision (Basel Committee) published many of the Basel III rules.[[1]](#footnote-2) These set out the details of the new global capital and liquidity standards for banks developed by the Basel Committee and endorsed in principle by the G20 Leaders at their November summit in Seoul. This note provides a high-level overview of the main Basel III capital and liquidity requirements and the timeline for implementation.

With the core framework being adopted by the national authorities, the focus of attention is now shifting towards implementation – determining business impact and planning for compliance. There are strong indications that even though the framework in principle is being adopted, actual implementation will become divergent across various jurisdictions. Although the transitional period appears long, the 2019 deadline to complete implementation should not distract institutions from the need to demonstrate capital and liquidity resilience much earlier and meet interim deadlines along the way.

Despite a lack of absolute clarity, it would not be worthwhile to wait until all ambiguities have been resolved. Prior experience with the Basel II framework has shown that early analysis, strategic evaluation, and robust planning are all crucial to success in the ultimate implementation. Firms must also remain flexible to adapt to subsequent changes and developments.

This document attempts to summarize the key details of the Basel III capital adequacy framework and explores some of the practical implications and considerations for firms to establish an effective and efficient implementation procedure.

The global economic crisis has provided an opportunity for a fundamental restructuring of the approach to risk and regulation in the financial sector. The Basel Committee on Banking Supervision (BCBS) has collectively reached an agreement on reforms to “strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector,” which is being referred to as “Basel III.” Under Basel III, each area of proposed changes has a separate consultation, debate, and implementation phase. As a result, compared with the implementation of the previous agreement (Basel II), this enhanced level of dynamism, complexity, and interdependency within the global regulatory landscape will likely add significant challenge to the implementation of Basel III

The recent G20 Summit in Seoul endorsed the Basel III agreement. The G20 also endorsed very long transitional periods for full implementation of the Basel III capital and liquidity proposals.

Despite the G20’s objective of establishing a level playing field for banks, the reality is that regulators in different national jurisdictions are taking different paths over key issues like governance and remuneration, taxes and levies, the treatment of systemically important institutions, the so-called “living wills,” the scope of supervision, and even accounting and disclosure.

This is partly driven by different starting points in terms of the impact on countries of the financial crisis, yet there remains underlying tension around the trade-off between safety within the financial system and its ability to support economic growth.

The risk and regulatory reform agenda represented by Basel III needs also to be examined in light of the global journey back towards financial stability. The need is for a set of guidelines that will mutually reinforce the stability of financial institutions’ fiscal soundness of the economies in which they operate.

What are the key outcomes?As part of the general high-level agreement on the proposals, regulators from various national jurisdictions made a significant compromise on the time line for implementation of the framework, as well as various areas of implementation, including the treatment of minority interests, Deferred Tax Assets, and the calibration of the leverage ratio, which were the subject of intense debate among the BCBS and banks. Other key items, such as how to deal with SIFIs (systemically important financial institutions, a.k.a. “Too Big to Fail”), have been deferred for implementation due to lack of agreement.

A summary of qualitative impacts of the proposals is:

*Impact on individual banks:*

* Weaker banks crowded out – under adverse economic conditions, with regulatory scrutiny ever more intensive, the weaker banks will likely find it more difficult to raise the required capital and, funding, leading to a reduction in different business models and, potentially, in competition;
* Significant pressure on profitability and ROE – increased capital requirements, increased cost of funding, and the need to reorganize and deal with regulatory reform will put pressure on margins and operating capacity. Investor returns will likely decrease at a time when firms need to encourage enhanced investment to rebuild and restore buffers;
* Change in demand from short-term to long-term funding – the introduction of two liquidity ratios to address the short- and long-term nature of liquidity and funding will likely drive firms away from sourcing shorter-term funding arrangements and more towards longer-term funding arrangements with the consequent impact on the pricing and margins that are achievable;
* Legal entity reorganization – increased supervisory focus on proprietary trading, matched with the treatment of minority investments and investments in financial institutions, is likely to drive group reorganizations, including M&A and disposals of portfolios, entities, or parts of entities, where possible.

*Impact on the financial system:*

* Reduced risk of a systemic banking crisis – the enhanced capital and liquidity buffers, together with the focus on enhanced risk management standards and capability, should lead to reduced risk of individual bank failures and reduced interconnectivity between institutions;
* Reduced lending capacity – although the extended implementation time line is intended to mitigate the impact, significant increases to capital and liquidity requirements may lead to a reduction in the capacity for banking activity or, at the very least, a significant increase in the cost of provision of such lending;
* Reduced investor appetite for bank debt and equity – investors may be less attracted by bank debt or equity issuance given that dividends are likely to be reduced to allow firms to rebuild capital bases, ROE and profitability of organizations will likely decrease significantly, and some of the proposals on non-equity instruments (if implemented) could start to make debt instruments loss-absorbing prior to liquidation for the first time. This will become evident through investor sentiment in the cost of new capital issuance and the interbank lending rate;
* Inconsistent implementation of the Basel III proposals leading to international arbitrage – if different jurisdictions implement Basel III in different ways, issues we saw under Basel I and Basel II with respect to international regulatory arbitrage may continue to disrupt the overall stability of the financial system.

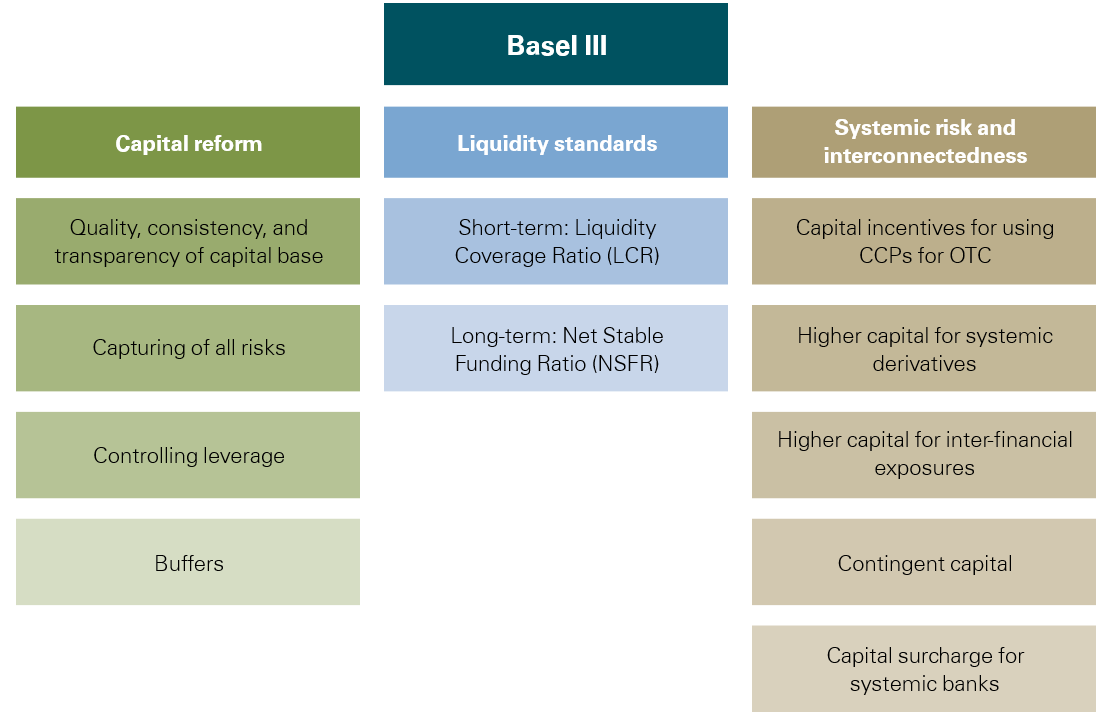
According to the BCBS, the Basel III proposals have two main objectives:

* To strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector;
* To improve the banking sector’s ability to absorb shocks arising from financial and economic stress, which, in turn, would reduce the risk of a spillover from the financial sector to the real economy.

To achieve these objectives, the Basel III proposals are broken down into three parts on the basis of the main areas they address:

* Capital reform (including quality and quantity of capital, complete risk coverage, leverage ratio and the introduction of capital conservation buffers, and a counter-cyclical capital buffer);
* Liquidity reform (short-term and long-term ratios);
* Other elements relating to general improvements to the stability of the financial system.

**Breakdown of the Basel III proposals[[2]](#footnote-3)**



The aim of the Basel III capital and liquidity standards is to make banks more resilient. However, Basel III also imposes costs on banks, reducing the returns that they can earn on their assets and increasing their cost of capital. It is to be expected that banks will seek to pass these costs on to their customers to the extent possible. The capital structure of many financial institutions looks set to change as a result of Basel III. Some banks have already embarked on core capital raising exercises which have helped to secure their capital adequacy ratios. It seems quite possible that more will follow.

1. Basel Committee on Banking Supervision, “Basel III: A global regulatory framework for more resilient banks and banking systems” (http://bis.org/publ/bcbs189.pdf) and “Basel III: International framework for liquidity risk measurement, standards and monitoring” (http://bis.org/publ/bcbs188.pdf), 16 December 2010. [↑](#footnote-ref-2)
2. www.kpmg.com [↑](#footnote-ref-3)