BIS Basel 3 regulatory consistency assessment

- The BIS preliminary report on the progress of the implementation of Basel 3 on capital requirements in the EU, the US and Japan drew sharp criticism from the European Commission. We find the BIS' findings, on the whole, fair and measured.
- We have made no changes to our normalised RWA and Capital models.

Background

The recent clash between Bank for International Settlements (BIS) and the European Commission (EC) deserves a highlight: public disagreements between such crucial transnational financial regulators hardly instil confidence.

In early Oct-12, in its Regulatory Consistency Assessment ('Level 2'[1]), the BIS commented on the progress of the implementation of Basel 3 reforms of capital requirements in the EU, the US, and Japan. The Assessment is preliminary - the follow-up will be published once the major jurisdictions finalise their rules for the implementation of Basel 3 – and it comments only on capital requirements: liquidity standards and leverage ratios have yet to be finalised by the Basel Committee.

Tracking developments in the banks' transition to Basel 2/3 and normalising risk-weighted assets (RWA) and equity/capital analysis forms a major part of our dynamic 360-degree profitability profiling of the banks we follow. The information provided in this Assessment will not result in changes to our existing models in any of the major jurisdictions; instead, this note offers our high-level thoughts on BIS Assessment's conclusions and the EC's response.

Comment

The BIS team assessed Japan's agencies as being compliant with Basel 3. The US agencies were assessed as compliant or largely compliant in 13 out of 14 areas; the one exception was securitisation, where the BIS team found US agencies as 'materially non-compliant' (MNC)[2]. The US banking agencies' response was mild and informative; and they thanked '…the assessment team for their conscientious and thorough analysis.'

In Europe, the BIS' report was received rather less well; in fact, we were surprised by the tone of the response from the European Commission.

BIS was commendably open about the specific limitations in its EU report, of which we highlight a few. Firstly, the report's findings are based on a modest small sample of banks: BIS requested data from 33 EU banks – six of which Financial Stability Board designated G-SIFIs in Nov-11 - but only 13 submitted 'substantially complete data' during six months of the preparation of the Assessment. Not surprisingly, the BIS team supplemented this data'set' with extrapolation and their own judgement – which, in *our* judgment, the members of the Assessment Team are very well-qualified to do[3]. Thirdly, the BIS team acknowledges that the supervision in Europe is decentralised, and that national authorities have wide-ranging powers. The BIS team found the EU approach compliant, or largely compliant in 12 out of 14 key components of capital requirements reforms; but it also assessed definition of capital and internal ratings-based approach for credit risk as MNC.

In short: BIS' report was openly preliminary, limited in coverage and 'hard' data it had at its disposal, heavily caveated and, we daresay, not on the whole terribly critical of the EU's progress. In its withering response to BIS' conclusions (published in the BIS report, alongside BIS' own conclusions), the European Commission (EC) forcefully disagreed. Our choice extracts – focusing on areas of particular importance for the banks we cover - are:

- The EC expressed reservations regarding BIS' conclusions in the two areas graded MNC by BIS: these, said EC '…do not appear to be supported by rigorous evidence and a well-defined

---

[1] *Basel Committee's review programme comprises three 'Levels': Level 1 = ensuring the timely adoption of Basel 3; Level 2 = ensuring regulatory consistency with Basel 3; Level 3 = ensuring consistency of risk-weighted assets (RWA).*

[2] *BIS definition of 'Materially non-compliant' grade: key provisions of Basel III have not been satisfied or differences that could materially impact financial stability or the international level playing field have been identified. The three other grades are compliant; largely compliant; and non-compliant.*

[3] *Team Leader: Charles Littrell, Australian Prudential Regulation Authority. Team members: Margaret Griffin, Reserve Bank of New Zealand; Anna Lee Hewko, US Federal Reserve System Board; Sandy Ho, Monetary Authority of Singapore; Satoshi Ikeda, Financial Services Agency of Japan; Marc Salomone, Swiss Financial Market Supervisory Authority. Support: Juan-Carlos Crisanto and Rajinder Jumar, Basel Committee Secretariat; Judy Lau, Australian Prudential Regulation Authority.*

assessment methodology.' This kind of criticism is seldom levelled at the venerable BIS; curiously, though, the EC apparently had no issue with BIS' methodology in the 12 areas graded compliant, or largely so.

- BIS found that 10 of the 13 'internationally active banks' reported CET1 ratio up to 0.5% above what would be the case if Basel rules were fully applied; and the remaining three exceeded Basel calculations by 1%+. The EC points out that the final legislation will apply to 8,000+ 'banks' (the term here including credit institutions and investment firms), and that some flexibility will be needed for 'non-internationally active banks'. If those include small and often troubled national players (Spain's cajas spring to mind, but also other GIIP banks, soon to be joined by their peers in Slovenia) flexibility, and more, will indeed be required. More to the point, though, we doubt BIS would object to a cautious approach.
- BIS expressed concern about the risk-weighting of sovereign paper held by banks. Exemptions, as defined by Basel, are meant to be applied only in special circumstances, rather than broadly; the EU, however, provided a wide ranging exemption. The BIS team concluded that the notional amount of exempted exposures at 16 banks for which data was available average 5.5%, and c.20% at one bank. The BIS team considered this material and so do we - indeed, considering the EU banks' lively LTRO/similar-fuelled investment into European sovereign paper in recent times, we are surprised the average exposure is not considerably higher than 5.5%. At any rate, few (certainly not us) would disagree with BIS' concern; but we do acknowledge the EC's politically difficult position.
- The EC further takes issue with BIS' implied assumption that the capital adequacy supervision will be, over time, watered down by various European authorities, and stresses '…the existing safeguards of disclosure and discipline though the European Banking Authority (EBA)[4]'. In our view, as long as EU banking supervision depends on national oversight, informal agreements can reasonably be expected, especially in the times of crisis. We also do not quite understand the value of the reference to EBA: to our knowledge, EBA is highly dependent on the cooperation of other European and national regulators and besides, its operational and institutional independence is questionable.
- The Basel framework excludes from Core Equity Tier 1 (CET1) unrealised gains/losses resulting from changes in fair value liabilities that are due to changes in a bank's own credit standing. The EU's proposed Capital Requirements Regulation (CRR), however, allow '…an offset for changes in fair value of hedges or other financial instruments also due to changes in the bank's own credit standing.' We agree with BIS (and the vast majority of market observers): fair value accounting for changes to a bank's own spreads (commonly, albeit often unclearly, referred to as CVA/DVA), which in past years frequently exceeded a bank's true profit, should not be included in the calculation of capital.

[4] *As it happens, EBA released a report barely a day after BIS' Assessment, and its findings were less than flattering. In Dec-11, EBA requested European banks raise EUR115bn/$160bn in new capital; EBA's goal is CET1 of 9%, and additional 'sovereign buffer', not hugely dissimilar from BIS' concerns. By end-June-12 deadline, European banks raised their capital reserves by EUR94bn/$122bn – a 1/3 of what they would have needed to be in full compliance with new Basel rules at end-2011.*

Notes & Caveats

This report and the information contained herein may not be reproduced or distributed in the whole or in part without the prior written consent of Tricumen Limited. Such consent is often given provided that the information released does not prejudice Tricumen Limited's business or compromise the company's ability to analyse the financial markets.

Tricumen Limited has used all reasonable care in writing, editing and presenting the information found in this report. All reasonable effort has been made to ensure the information supplied is accurate and not misleading. For the purposes of cross-market comparison, all numerical data is normalised in accordance to Tricumen Limited's proprietary product classification and may contain +/-10% margin of error.

The information and commentary provided in this report has been compiled for informational purposes only. We recommend that independent advice and enquiries should be sought before acting upon it. Readers should not rely on this information for legal, accounting, investment, or similar purposes. No part of this report constitutes investment advice, any form of recommendation, or a solicitation to buy or sell any instrument or to engage in any trading or investment activity or strategy. Tricumen Limited does not provide investment advice or personal recommendation, nor will it be deemed to have done so.

Tricumen Limited makes no representation, guarantee or warranty as to the suitability, accuracy or completeness of the report or the information therein. Tricumen Limited assumes no responsibility for information contained in this report and disclaims all liability arising from negligence or otherwise in respect of such information.

Tricumen Limited is not liable for any damages arising in contract, tort or otherwise from the use of or inability to use this report or any material contained in it, or from any action or decision taken as a result of using the report.