The rush to uncertainty

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The Bracken column is named after Brendan Bracken, the founding editor of The Banker in 1926 and chairman of the modern-day Financial Times from 1945 to 1958. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.

ON DECEMBER 17, 2009, the Basel Committee on Banking Supervision (BCBS) published its much-anticipated proposals for strengthening the resilience of the banking sector and the international framework for liquidity risk management. The proposals are wide ranging and will have a significant impact on banks and other regulated financial institutions.

The BCBS consultation period ends on April 26, with an intention for concrete changes to be announced by the end of 2010. The proposals have been welcomed in many quarters as an important step in ensuring regulatory capital better reflects the risks undertaken by individual banks and that they are in a better position to withstand future financial crises. Concerns have been raised, however, that a number of the changes are being pushed through in an accelerated timeframe under political pressure from the G-20 and, in cases such as the proposed liquidity framework, are not consistent with other developments already in progress.

CAPITAL REQUIREMENTS

The key aspect of the BCBS's proposals relate to regulatory capital requirements. In particular, Tier 1 capital will be required to comprise predominantly of 'common equity' to be limited to common shares and retained earnings. A bank's remaining Tier 1 capital will be required to satisfy strict criteria, including that it be fully subordinated to depositors, be perpetual with no incentive to redeem and contain other restrictions. Major changes will also be made to adjustments permitted to the common equity component of Tier 1. Controversially, minority interests will be excluded from the calculation of common equity and there will effectively be a full deduction against Tier 1 capital for certain items, including some securitisation products, where the deduction is currently applied equally between Tier 1 and Tier 2. The distinction between lower and upper Tier 2 capital will be eliminated and Tier 3 capital abolished.

The proposals in relation to capital are likely to increase both the cost of capital to banks and the risk weighting of many assets against which capital must be applied. Among the concerns raised by banks is their ability to raise capital through innovative financial instruments. German banks, which have relied heavily on the ability to issue hybrid financial instruments, have voiced apprehension at the impact such changes would have, including the lack of clarity as to whether any such instruments issued after December 2009 will be 'grandfathered' when the rules become effective. Although banks should be able to continue to use innovative instruments such as contingent convertible bonds (Cocos) to raise some Tier 1 capital, the restrictions imposed by the new rules are likely to result in the pricing of such instruments being significantly higher than previous hybrid instruments.

The BCBS is also seeking to tackle the counterparty credit risk arising from banks' derivatives, repo and securities financing activities. The new rules will encourage banks to use central counterparties for over-the-counter derivative contracts by imposing more rigorous collateral management and margining requirements, and additional capital charges for transactions not cleared through such arrangements. Considerable work is already under way within the EU and among national legislators and regulators, including in the US, to develop rules in this area, although, in most cases, concrete legislative proposals are not expected until later in 2010.

CONSTRAINING ORDER

Other important aspects of The BCBS's proposals include the introduction of a leverage ratio intended to constrain the build-up of excessive leverage (which has been welcomed in the US where a leverage ratio already exists but criticised in other quarters, notably Germany, as unlikely to make the sector safer) and measures designed to reduce pro-cyclicality (including capital buffers above the regulatory minimum). In addition, suggested changes to the liquidity framework go further than other initiatives in this area, including the guidelines on liquidity buffers published by the Committee of European Banking Supervisors in December 2009, which banks must start applying by the end of June 2010.

It would be almost impossible to ascertain whether all the elements can work on a global basis until some of the other national and international initiatives in relation to bank regulation are further developed. Although the changes are designed to reduce the risk of difficulties in the financial markets triggering further financial crises, there is a danger that if the new rules are too restrictive, they could unduly constrain the capacity of banks to lend, which is likely to hamper recovery and growth. TB

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