

Basel III: Update and Implications to Canadian Investors

CIBC MELLON



MARCH 2011

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Across the globe, organizations are beginning to react to the new, more stringent regulations required as a result of Basel III. Firms in all sectors of the financial services industry are looking closely at the new capital requirements and working to understand the impacts of the redefinition of capital and how best to achieve and maintain the minimum requirements. Canadian regulators, working closely with the Basel Committee and the Bank for International Settlements, are looking to Canadian financial institutions to act responsibly and continue making prudent decisions. CIBC Mellon continuously monitors the regulatory environment to respond effectively to the rapidly changing needs of clients.

Basel III: Discussing upcoming changes

On December 16, 2010, the Basel Committee on Banking Supervision released the text of the Basel III rules and the results of its Quantitative Impact Study. It is within this text that specifics around what types of assets are to be included and excluded from common equity calculations and what will be the minimum capital and liquidity ratio standards that financial institutions must maintain. This was an important next step in the adoption and implementation of Basel III capital and liquidity standards globally.

With the objective of creating a framework “that will help protect financial stability and promote sustainable economic growth,”¹ Basel III takes both macro- and micro-prudential points of view. At a macro level, the committee is focusing on ensuring new requirements do not inadvertently create tighter restrictions on lending, and on building a foundation of stability in countercyclical markets. Adjusting capital tier 1 and total ratios, ensuring more complete and appropriate risk coverage, and the inclusion of leverage ratios are all focuses of the report from a micro-prudential view.

Canadian perspective

In a recent speech, Assistant Superintendent Mark White of the Office of the Superintendent of Financial Institutions (OSFI) in Canada, outlined several key components of the Canadian banking system that, in combination, helped sustain the stability of the financial industry. These included:

- A healthy economic and policy backdrop,
- A robust and flexible financial regulatory framework,
- Effective supervision, and
- Generally prudent practices of Canadian financial institutions.²

Though Canada fared well during the crisis, it is important to be an active participant in these reforms. As a G20 member, Canada sees the importance of being “prepared to fight the next war, not the last” and understands “that a more stable global system is in everyone’s interests.”

Currently, under Basel II regulations, financial institutions are required to maintain a 4% tier 1 capital ratio and an 8% total capital ratio. However, Canadian financial institutions, as stipulated by OSFI, are required to keep much higher ratios: 7% tier 1 and 10% total capital. In addition, according to OSFI, “at the end of the first quarter of 2009, their average tier 1 capital ratio was 10% and the total capital ratio stood at almost 13%.” Though changes to the definition of what constitutes “tier 1” common equity will impact Canadian banks, Basel III ratio thresholds are very much inline with Canadian standards.³ However, as the new requirements are phased-in, financial institutions will be challenged to appropriately manage their asset mix to ensure compliance.

Cooperation, transparency and guidance are the commitments that OSFI has made to both the Basel Committee and the Canadian financial sector. It has stated clearly that OSFI expects banks to continue making rational decisions and that these new rules should not change this approach to management. Rather, these reforms “merely constitute a new regulatory minimum and do not change a bank’s responsibility to make its own prudent decisions to protect depositors, to innovate and to succeed.”³

A timeline for the future

Globally, the Basel Committee has set important timelines and is putting frameworks in place to safely and rationally introduce the new rules. Monitoring, assessing, and revising have become the key messages from their implementation strategy. The Committee has outlined several important milestones on the road to full implementation:

- 2010 – November: G20 endorses Basel III
- 2011 – Core principles revised as a result of the Financial Stability Board’s recommendations
- 2013 – Liquidity Coverage Ratio (LCR) impact assessment and revisions as required
- 2015 – Short-term LCR standards released
- 2016 – Net Stable Funding Ratio (NSFR) impact assessment and revisions as required
- 2017 – Final review and adjustments
- 2018 – January 1: Pillar 1 treatment – Basel III implemented
- 2018 – NSFR minimum standards put in place⁴

Nine Breakthroughs

Hervé Hannoun, Deputy General Manager of the Bank for International Settlements, in a recent speech described nine “breakthroughs” that he believes will be realised as a result of Basel III implementation. Collectively, these items represent the next steps the Committee feels are required in order to begin introducing long-lasting stability into the global banking system:

- **Focusing on high-quality common equity.** The types of capital to be included and excluded from capital ratio calculations will now more accurately reflect a financial institution’s capacity for reacting to market volatility.
- **Trading book risk coverage.** Financial institutions will be required to hold an average of four times the capital previously required to cover trading book exposures.
- **Seven per cent common equity ratio.** Financial institutions will be obliged to carry a minimum of 4.5% of risk-weighted assets in tangible common equity and an additional 2.5% in a capital conservation buffer.
- **Enforcing capital conservation.** Banks will be required to pursue distribution policies that are consistent with sound capital conservation principles.
- **Basel III is a framework that remains risk-based** but now includes – through the tier 1 leverage ratio – a backstop approach that also captures risks arising from total assets. The risk-based and leverage ratios reinforce each other.
- **The introduction of a countercyclical capital charge** to mitigate the procyclicality caused by excessive credit growth.
- **Systemically important financial institutions** need higher loss-absorbing capacity to reflect the greater risks that they pose to the global financial system. A systemic capital surcharge is the most straightforward, but not the only way to achieve this.
- **Too connected to fail.** Managing and avoiding the thinking that a financial institution is too large to fail.
- **Guidance and supervision.** Supervisors should avoid over-reliance on banks’ internal models, and their supervision needs to be more intrusive to ensure that systemic risk and tail events are adequately captured in banks’ risk modelling and stress testing.⁵



Monitoring progress

The message consistently expressed by members of the Basel Committee on Banking Supervision is one of collaboration and monitoring. As the new framework is implemented throughout the global financial services community, deliberate assessments and revisions are planned. At CIBC Mellon, we continue to monitor the progress of the Basel Committee. As changes to reporting and investment monitoring evolve, we are ready with the most sophisticated technology and asset servicing solutions to meet the needs of our clients in Canada and abroad. For further information or to discuss your firm's specific requirements, please contact David Linds or visit cibcmellon.com.

¹ "Basel III: A global regulatory framework for more resilient banks and banking systems." Basel Committee on Banking Supervision. December 2010. www.bis.org.

² "Basel III: Balancing of risk and regulation." Mark White, January 11, 2011. www.osfi-bsif.gc.ca.

³ "Lessons for banking reform: A Canadian perspective." Central Banking, 19, #4, Carol Ann Northcott, Graydon Paulin, Mark White.

⁴ "Basel III and beyond." Nout Wellink, January 17, 2011. www.bis.org.

⁵ "The Basel III Capital Framework: a decisive breakthrough." Herve Hannoun, November 22, 2010. www.bis.org

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