Regulatory Capital: The Evolving Regulations Stemming from Basel II & Basel III Proposals

By Michael Awoliyi

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MISSION

To positively unlock opportunities in the society.

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SIMPLICITY

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Trust is at thecore of who we are. On this, we are uncompromising.

F I R S T

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Introduction

- *The Central Bank of Nigeria (CBN), as part of its efforts to enhance the resilience of Deposit Money Banks (DMBs) and the Nigerian Banking System, created a Revised Guideline on Regulatory Capital, which sets out the criteria that banks' capital instruments must meet to be eligible for regulatory purposes as per the Basel III standards.*
- *This Guideline also sets out the supervisory requirements for banks operating in Nigeria in relation to: minimum regulatory capital, adjustments to the components of regulatory capital, transitional arrangements, disclosure requirements and the additional capital buffers above the minimum requirements.*
- *The aim of this Guideline is to further strengthen the resilience of Nigerian banks by increasing the minimum requirement for high quality capital which can absorb losses on a going concern basis, and by requiring banks to build up additional capital buffers to cushion against future unexpected losses*

Source: https://bit.ly/40UkQE9

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Acknowledging Short Comings of Basel II

Despite Basel II's emphasis on the latest risk assessment models, the recent global financial crisis showcased the limitations of that framework in several areas:

1

- Banks naturally took advantage of the rather loose definition of Tier 1 (left largely intact from Basel I) by structuring financial products that enabled them to comply with Basel II with lower costs of capital.

- Indeed, some regulators observed that through the use of these instruments', banks were able to comply technically with Basel II capital requirements while holding as little as 1 percent common equity on their balance sheets.

2

- There were concerns regarding how banks structured their liabilities. For example, the capital requirements for trading book assets and securitizations under Basel II were comparatively low—especially when compared to assets registered on the book.

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- The financial crises revealed critical flaws in the risk management models used by the majority of financial institutions globally.
- Similarly, the reputation of credit ratings agencies didn't fare much better during the crises.

4

- Basel II, according to the Basel Committee on Banking Supervision (BCBS), failed to capture major on and off-balance sheets risks i.e. unused commitments, letters of credit, as well as derivative related exposures. .

5

- Finally, and most importantly, the financial crises illuminated a de facto erosion in capital levels over the past decades that had left far too many banks ill-equipped to absorb significant losses. In fact, insufficient capital buffers were particularly acute in the case of a number of systemically important financial institutions (SIFI).

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HIGHEST PRIORITY ISSUES" FOR THE BASEL COMMITTEE IN DESIGNING BASEL III

Creating Operational Resilience

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Increasing the Quality and Quantity of Capital

Among the “highest priority issues” for the Basel Committee in designing Basel III was the “need to strengthen the quality, consistency, and transparency of the regulatory capital base and high-quality buffer that can absorb losses during periods of economic distress.

Basel III aims to strengthen the fundamental definition of capital, with a focus on its overall quality, transparency, and consistency:

Basel II set the risk-weighted capital requirement at eight percent, with total capital divided 50/50 between Tier 1 and Tier 2 .

Basel III maintains the requirement that a bank’s “Total Capital” must be at least 8 percent of RWAs. But Basel III requires that at least 75 percent of a bank’s Total Capital consist of Tier 1 capital, with only up to 25

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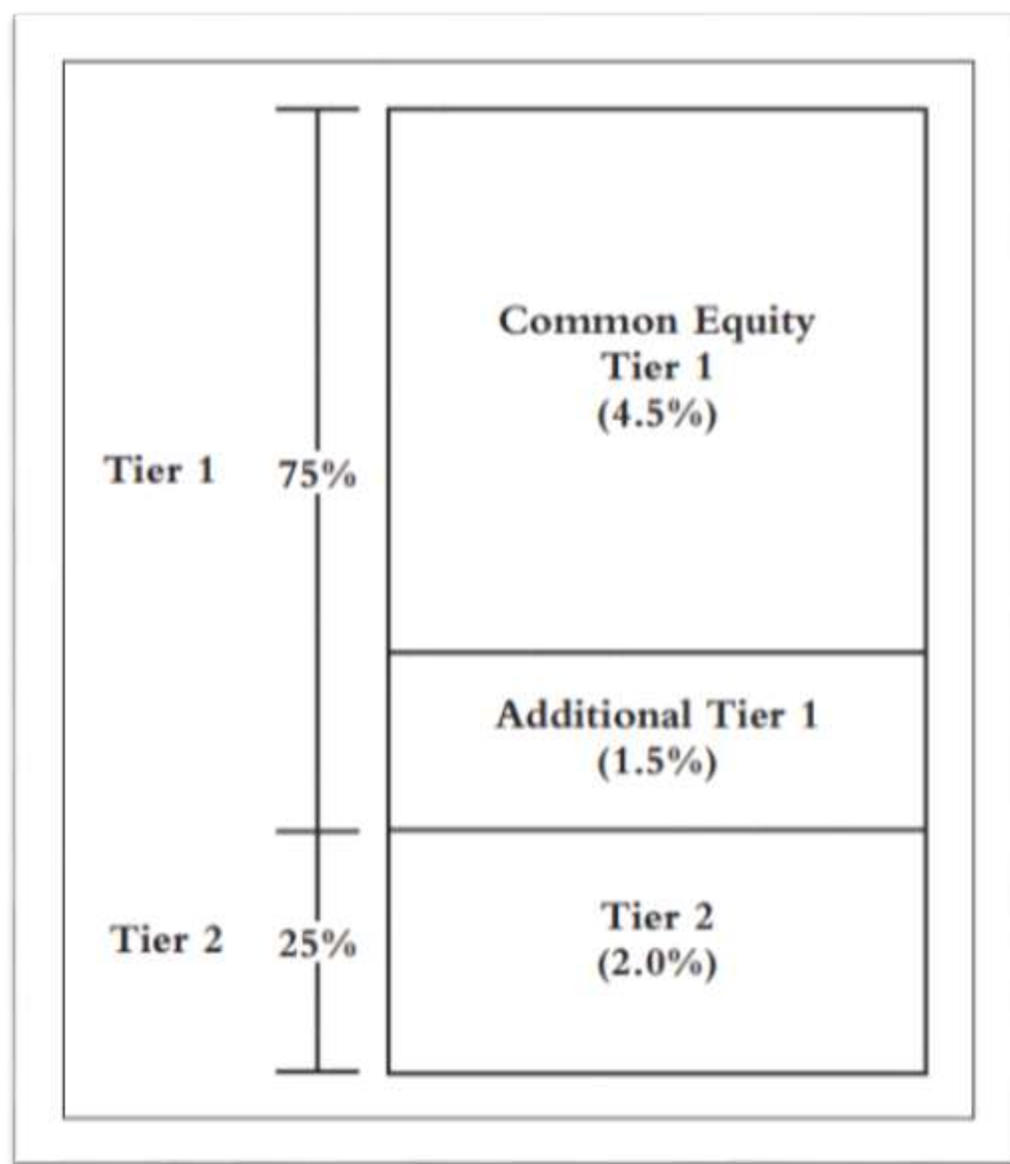


Basel III breaks down Tier 1 into two categories: "

Common Equity Tier 1" and "Additional Tier 1.", where both categories are expected to make up 75% of regulatory capital

While Tier 2 consist of 25% of Capital

Increasing the Quality and Quantity of Capital – Basel III Model

Common Equity Tier 1 - Includes the sum of common stock satisfying the following criteria:	
	Surplus from common stock issuances;
	Retained earnings;
	Other comprehensive income;
	Minority interests in the common stock of consolidated subsidiaries; and
	Certain regulatory adjustments

Additional Tier 1 capital essentially consist of various types of preferred stock and additional paid-up capital that do not satisfy the standards of Common Equity :	
	Preferred stock that is subordinated to depositors, general creditors, and the subordinated debt of the company.
	Certain instruments issued by consolidated subsidiaries of the company held by third parties
	Regulatory adjustments to capital are also included in Additional Tier 1 Capital

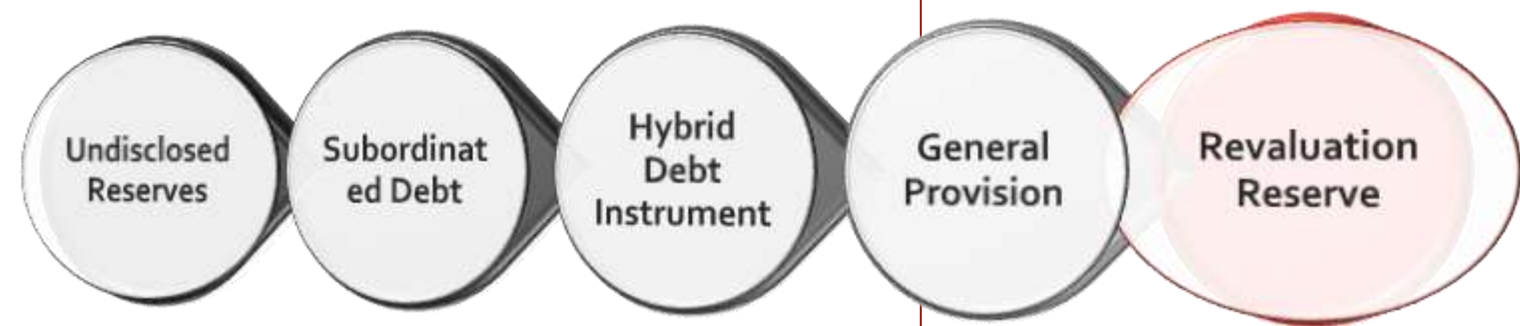
Increasing the Quality and Quantity of Capital – Basel III Model

Tier 2 Capital - Includes :	
	Preferred stock with non-perpetual and debt-like features
	Various types of subordinated debt
	Variety of instruments that fail to qualify for Tier 1 Capital i.e. instrument at issue is subordinated to depositors and general creditors; is neither secured nor guaranteed by the bank; has no credit sensitive dividend features;

Tier 2 capital is to provide loss absorption on a "gone-concern" basis.

Tier 2 is absorbed by a financial institution as it becomes insolvent.

Tier 2 capital provides a cushion consisting of lower forms of equity and junior liabilities



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Establishing Additional Buffers

During the early stages of the crisis, some financial institution continued to distribute dividends and bonuses. These distributions arguably eroded capital reserves and reduced the ability of financial institutions to absorb additional losses hence, the need to establish additional buffers through Basel III.

Because of the above, the following key points came to the limelight:

1) Capital Conservation Buffer

- Requires banks to hold an additional 2.5 % of Total Capital in the form of Common Equity Tier 1, over and above the 4.5% minimum mentioned above
- A dip below the minimum will require a company to rebuild its buffer through a reduction of discretionary distributions.
- In the event a bank fails to do so voluntarily, Basel III encourages regulators to enforce reductions of discretionary distributions until the buffer is are established.

Common Equity Tier 1 Ratio (%)	Existing Buffer (%)	Minmum Capital Conversion Ratio (% of earnings banks are required to hold to rebuild buffer)	% of earnings available for discretionary distribution
4.5-5.125	0-0.625	100%	0%
>5.125-5.75	0.625-1.25	80%	20%
>5.75-6.375	1.25-1.875	60%	40%
>6.375-7	1.875-2.5	40%	60%
>7	2.5	0%	100%

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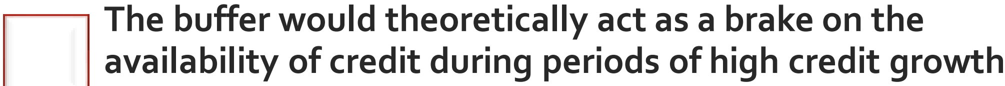
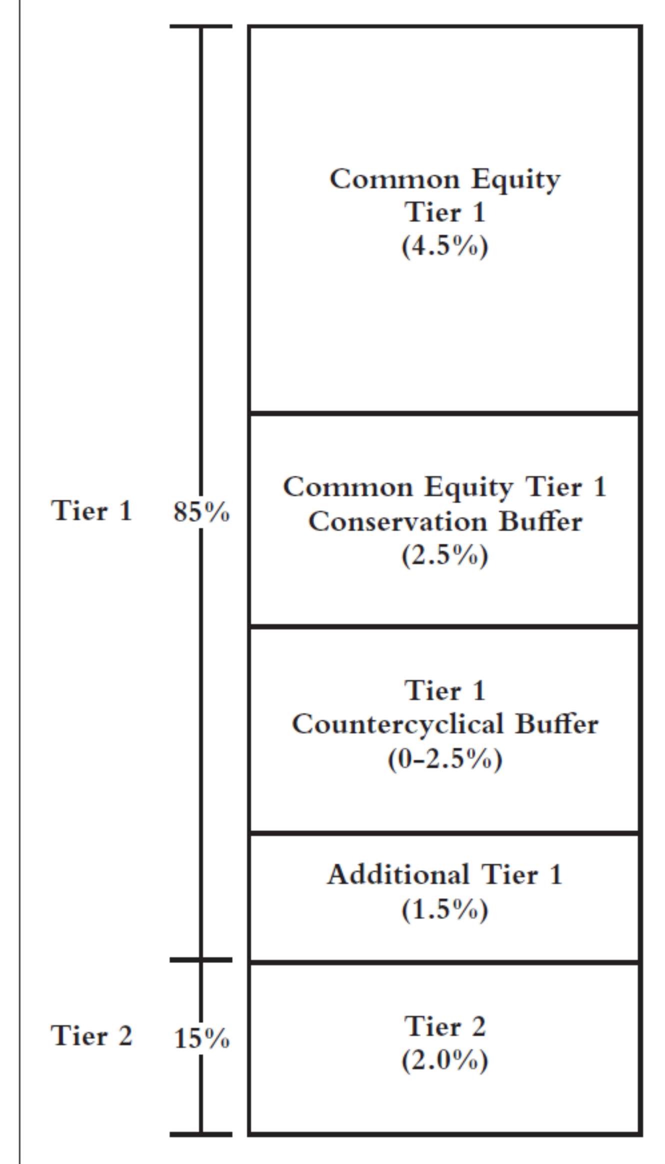
2) Countercyclical Buffer



The buffer would theoretically act as a brake on the availability of credit during periods of high credit growth

The buffer will simultaneously lessening pressure to restrict credit during a downturn.

As a practical matter, Basel III relies on each national jurisdiction to monitor credit growth in relation to objective measures such as GDP.

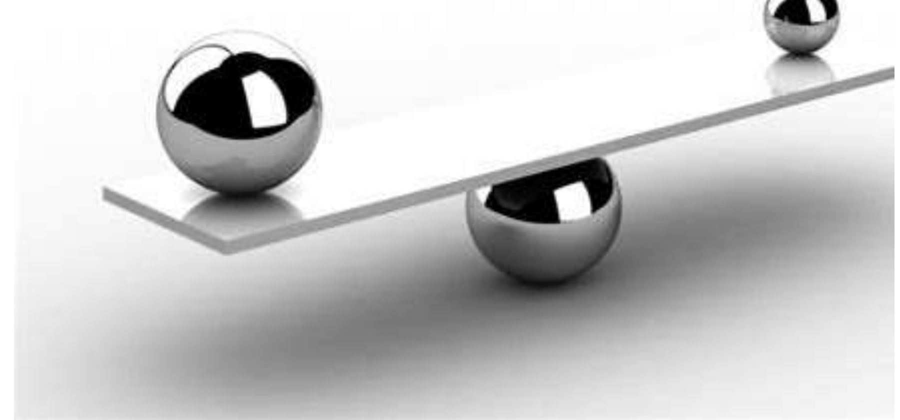


Capital Ratio (with Buffers)

Introducing a Leverage Ratio

Basel III rejects the notion that capital requirements should be maintained solely on the basis of RWAs. Prior to the crisis, a number of banks and other financial institutions built up leverage that was seen as excessive, while still showing strong capital ratios as measured against RWAs.

As a result, the Basel Committee adopted an additional measure to reinforce existing risk-based capital requirements. Basel III's "leverage ratio" is calculated by comparing Tier 1 capital with "total exposure," without reference to RWAs. The overall target is a leverage ratio of at **least 3% (** *i.e.* , Tier 1 capital should be at least three percent of total leverage).



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Managing Counterparty Risk

The shortcomings of the Basel capital adequacy framework were particularly apparent in the assessment of risks arising from on- and off-balance sheet transactions and derivatives-related exposures. **Basel III emphasizes the importance of calculating financial institution's capital needs under the "worst case scenario."** In doing so, the the Basel Committee on Banking Supervision (BCBS) focuses on a number of key topics as discussed below:

Stress testing of default risk :	Company's will be required to calculate their default risk capital charge using a stress calibration as part of the exposure calculation
Credit valuation adjustment:	In addition to default risk capital, financial institutions are required to hold capital against marked-to-market losses arising from a decline in counterparty creditworthiness.
Wrong-way risk:	Another measure to improve counterparty credit risk evaluation is the identification and mitigation of "wrong-way risk." This risk arises when an exposure to a counterparty increases as the counterparty's creditworthiness declines

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Improving Liquidity

In some sense, the global financial crisis was not so much a capital crisis but rather a **liquidity crisis**, at least initially.

Specifically, the Basel Committee has introduced two minimum standards for liquidity: the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

Liquidity Coverage Ratio

- The Liquidity Coverage Ratio (LCR) is designed to ensure that an internationally active bank has sufficient unencumbered, high-quality liquid assets to offset the net cash outflows it could encounter under a month long acute stress scenario that includes both systemic and institution-specific shocks

LCR Formula

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100\%$$

The LCR requires that a bank's stock of high-quality liquid assets be at least equal to its total net cash outflows for the next 30 days

Net Stable Funding Ratio

- NSFR seeks to promote medium- and long-term funding by establishing minimum amounts of liquidity based on a bank's assets and activities, including those related to off-balance sheet (OBS) commitments over a one-year period of extended stress.

NSFR Formula

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

The NSFR requires that Available Stable Funding (ASF) exceed Required Stable Funding (RSF) for assets and OBS exposures.

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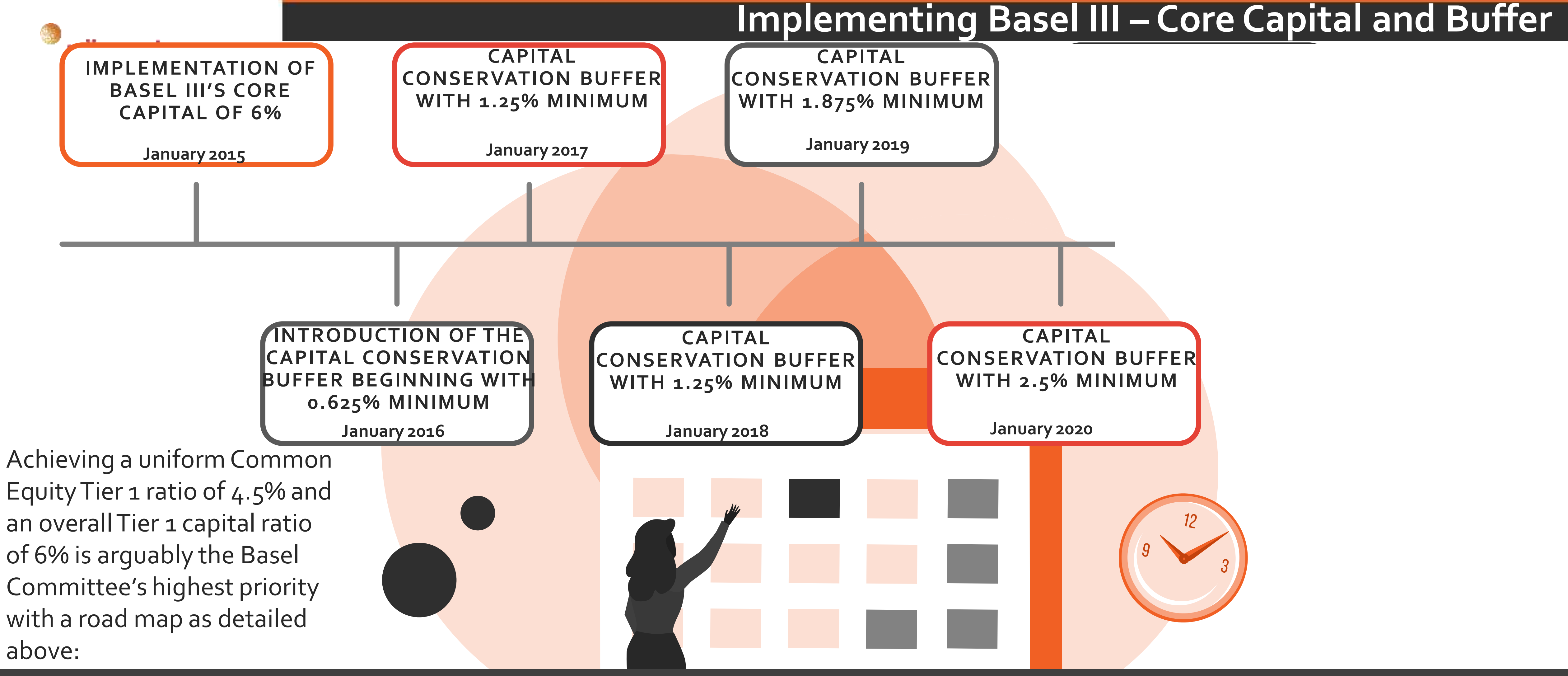

Implementation timeline

Quiz

1. What is the composition of Tier 1 Capital.
2. Examples of off-balance sheet items?
3. Tier 2 capital includes?
4. What must be considered before discretionary distributions and what is the minimum buffer ?
5. What is the current Cash Reserve Ratio and Liquidity Ratio as well as its impact on stability in the financial industry in Nigeria.

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CONCLUSION

Basel III represents a significant milestone in the development of uniform capital requirements. In particular, Basel III's emphasis on the quality and quantity of core capital—with the overriding goal of fortifying bank capital cushions on a global basis—is the framework's very cornerstone.

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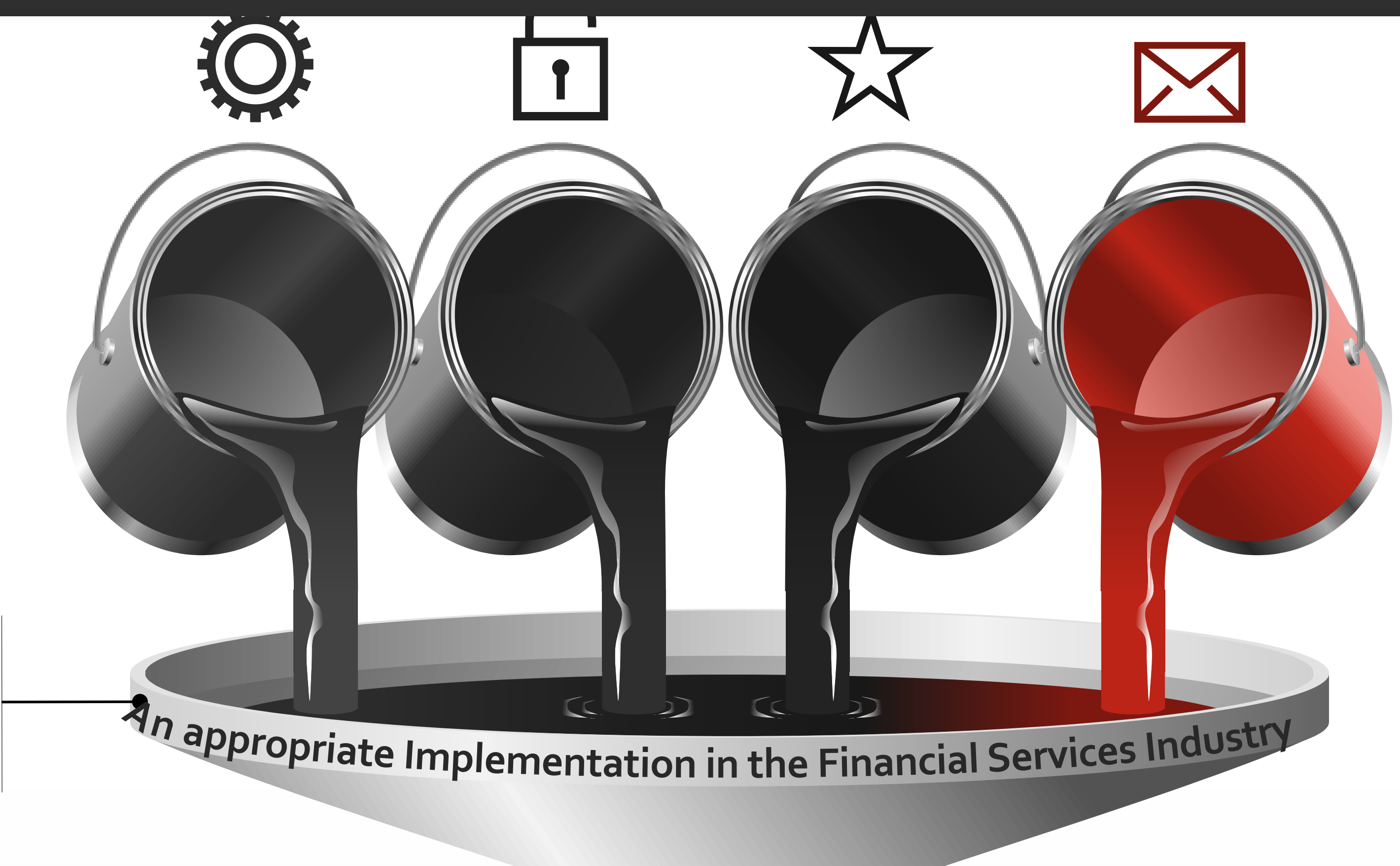

The Global Financial Service Industry

Expected Result?

A Strong, vibrant and Resilient Financial Industry

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