BASEL III – IMPLICATIONS OF THE NEW AGREEMENT UPON THE BANKING SYSTEMS

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Abstract. *Global banking crisis generated by the subprime crisis in the U.S., received in December 2010, as a response from the Committee on Banking Supervision of the Bank for International Settlements, new capital adequacy rules for banks under the Basel III title: International framework for measurement, standardization and monitoring of liquidity risk, and Basel III: A global regulatory framework for banks and a sounder banking system with new capital adequacy rules for banks. These regulations are the focus of global financial reform to prevent future occurrence of banking crises.*

Key words*: Basel III, global framework, capital, bank*

1. Introduction

According to its promoters, Basel III Accord represents a joint between prudential micro and macro-supervision, representing in the same time a framework for risk management at the bank level (taken from Basel I and Basel II) and a framework for systemic risk management at the level of the banking system.

Since the new agreement involves increasing bank capital, the term full implementation of the Agreement was estimated at the end of 2018, due to the fact that the new agreement involves increase of the banks' capital; this extended implementation period is necessary in order to give banks enough time to set up the additional capital, and also to be able to manage the impact of this agreement upon the banking activity.

2. Regulations of Basel III Agreement and their propagation in the banking activity

The expression of a vulnerable fund regulatory and supervisory framework for the banking system, triggering the global financial crisis has imposed a number of measures and regulations. This, at international level, there is a consensus on updating and revising the regulatory and supervisory framework of banking activities, which was materialized in the authorities' approach to implement Basel III Agreement progressively, in the following years.

In contrast to Basel II regulations which have generated increasing risk sensitivity and inefficient coverage of capital requirements, as fluctuations from the economic cycles determined the of the quality of assets and passive elements form banks' balance sheets, and also uncontrolled exposure of off-balance elements that has occurred, Basel III Agreement has revealed new aspects that should be considered in relation to management of banking risks. "Basel III: A global regulatory framework for more resilient banks and banking systems" outlines the need for treatment the risks more comprehensively, and especially those arising from capital market transactions, and to increase the quality of capital to cover losses [1].

Basel III has a micro framework aimed at new items for all three components of the equation of capital: regulatory capital to risk-weighted assets and solvency ratios.

Basel III Agreement emphasizes the importance of financing by issuing common shares. At the same time, it imposes stricter transparency rules regarding the capital.

As for the risk-weighted assets, Basel III Agreement imposes higher capital requirements for trading activities on financial markets.

Regarding the solvency ratio, under the new agreement, requires that banks impose a minimum level of common capital reserve, representing 4.5% of risk-weighted assets, capital obtained from the issuance of common shares (compared to 2% as in Basel II Agreement). Also, tier 1 capital requirement shall be increased to a minimum of 4% to 6% level, while maintaining the minimum capital ratio of 8%.

Preservation of capital is a new element of this is represented by the preservation of capital; thus, Basel III introduces a requirement that banks must maintain a buffer capital of 2.5% of risk-weighted assets, capital set up based on the issuance of common shares, by increasing common capital ratio at 7%. As an exemplification, when the capital ratio falls, the buffer capital is used to cover losses, and the agreement imposes the banks to keep a major share of revenues obtained in order to set up again this capital as well as restrictions on the distribution of dividends, purchase of the own shares and distribution of discretionary bonuses.

Therefore, it is estimated that the new regulatory capital requirements (Tier 1 common capital and Tier I capital) will be implemented gradually, between 2013 to 2015, moreover, the Romanian Banking Association considers the new agreement too restrictive and underlines the danger that banks reduce their appetite for lending to businesses, which would affect also the main activities of banks, i.e. to finance the economy. It is known to us that requests were presented to the European Parliament and to the European Commission in order to change the new capital regulatory framework proposed by the Romanian Banking Association and approved by other European banking systems and banking groups that adhered to this proposal [2].

The macro-prudential framework represents another aspect of novelty brought by the new agreement, manifested at the level of banking system, in trying to fight against the systemic risk, dimension consisting of five elements:

- Leverage ratio (leverage ratio);
- Measures to avoid pro-cyclicality;
- The macro-prudential system for important banks for the banking system;
- The macro-prudential system for important markets and infrastructure for the banking system;
- Management of systemic risk.

In the opinion of specialists, the introduction of these measures the expression of new requirements for credit institutions that are meant to unify European supervisory practices and to introduce liquidity management at the level of group, imposing banks to hold a capital at a higher qualitative and quantitative level, that would ensure their resistance independently of potential shocks they might face in the future.

We do appreciate the statement made by the economist Minsky, who brings in prime plane the role of human behaviour whose contribution increases financial shocks, exposing financial institutions and markets and ultimately, the economy as a whole [3].

At the same time, other economists invoke the imperative character of continuing the wave of regulations known under the denomination of Basel III, in order to carry forward the current regulatory prudential framework and to address issues that are not covered by Basel III, as this is not sufficiently calibrated, while its real impact on markets and economy is barely known. Negative aspects invoked refer to the inability of markets and real economy to resume re-launching [4].

3. The Impact of the new agreement on banking activity

The consequences of globalization and competition among banks imprinted them the uncontrolled use of innovative financial instruments, in their attempt to maintain profitability, although at the same time, there is an increase in leverage (i.e. a high level of debt employed). So, the exaggerated concern of banks to provide financial innovations for trading, difficult to assess, led to the underestimation and concentration of risk, resulting in further erosion of their capital, situation that imposes a revised regulatory framework of the banking system.

The emergency to comprehensive treat the risks especially those arising from capital market transactions and growth capital to cover losses quality are prioritized by the Basel Committee on Banking Supervision, in the document "Revisions to the Basel II market risk framework , "published in February 2011.

We learn that those alerts are imposed as a result of a risk management that underestimated the economic capital of banks under conditions of financial markets stress. Also, recent research shows that during 2007-2009 most banks recorded significant losses as compared to minimum capital requirements determined in accordance with regulations relating to market risk under Pillar 1 (Basel II).

At the same time, an inadequate level of capital and hence of the liquidity, represented the collapse of some banks, and reorganizations of activity for others. Therefore, regulation of the new agreement impose capital adequacy according also to the liquidity of financial instruments and take into account especially less liquid instruments, which are issued for a longer time period.

At the level of the Romanian banking system, a level of protection is maintained against adverse trends occurred at international level, and this has been possible through the level and quality of own funds that by the mid-2013 were within adequate limits, namely:

- Solvency ratio of 14.7%, records a significant level compared to the minimum requirement level of 8%;
- Tier I own funds ratio records a level of 13.6%, compared to the minimum requirement of 6%.

Processes recorded by parent banks to strengthen capital related to capital increases in order to meet the requirements of the New Basel influenced the external financing, which continued its downward trend in an accelerated rhythm during the period August 2012-August 2013, from -7.1% to -15.5%. Having noted that, the capital structure maintains an appropriate structure, its volume being represented by approximately 70% of share capital / endowment (i.e. private shareholders' contribution in credit institutions) [5].

The National Bank of Romania (NBR), in its supervisory activity, imposes measures aimed at financial stability, among which we mention the supervision of branches liquidity to fall in the responsibility of the competent authority from the host Member State and liquidity standards should be applied at individual level, even if they are satisfied at consolidated level.

Referring to the above indicators, recorded by Romanian banking system and relating to the assessment of capital adequacy against risks, we can theorize the possibility of proper implementation of the new Basel III regulations that will be transposed in the national legislation through the legislative package CRDIV / CRR [6] implemented gradually from 2014 until the end of 2018, under the conditions of continuous activity.

4. Conclusions

The implementation of the Basel III New Agreement at the level of the banking systems plays a significant role in their structure and dynamics and in order to ensure the success of this agreement we propose and encourage the following measures:

1. Supporting until the approval by the European Parliament and the European Commission the request presented by the Romanian Banking Association relating the amendment of the new capital regulatory framework – The agreement is considered as a restrictive one in terms of risk-taking by banks and there is a danger that banks reduce their appetite for lending to SMEs as a new loan granted to a corporation must be risk weighted 100%, which automatically leads to attracting more capital from shareholders, and it is quite worrying for both the banking community in Romania and for the European banking community;

2. The preservation of capital quality through the options that banks can access in order to reduce the impact of the Basel adoption - Reactions of credit institutions to the new standards will differentiate, depending on the transition period that is necessary to fulfil the requirements (e.g., for a short transition period banks could opt to reduce the supply of loans in order to increase the level of capital, changing the asset structure);

3. An efficient banking governance, adequate for a business model and for a corresponding risk profile - The purpose of banking activity is the profitability, but the absence of critical analysts who can advise and manage improvements in the activity leads to alterations in the system stability, which is still felt as consequence of the global crisis;

4. Awareness of the importance to improve the ability to transfer risks by every bank - each bank being forced to invest permanent capital management beyond single effort to align the balance to the new capital requirements;

5. Ensuring harmonization of banking products and services to customer needs in accordance with the interest and capacity of the bank - A bank diagnosis is determined by the structure of its own capital and by the liquidity level, and the existence in the bank 's portfolio of bad loans as a result of improper placement of capital and / or the predominantly existence of certain sources characterized mainly by instability or by short term, contributes significantly to change of liquidity up to inability to improve risk of bankruptcy.

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