Reform of bank capital regulation enters final phase

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Tuulia Asplund
Senior Economist

The capital requirements for banks were revised recently to improve the financial system's resilience to shocks. What remains is the finalisation of the reforms and the specification of implementation. The assessment and monitoring of the overall impact of regulation is important to ensure fair competition between banks and the financial system's ability to support sustainable economic growth.

Banks and credit institutions must hold an adequate amount of own funds to cover risks to their operations and possible losses in a crisis. Capital regulation defines the quality and minimum amount of capital[1] banks are required to hold, relative to their total risk exposure.[2] The global financial crisis that started in 2008 revealed that banks' capital requirements were too low and of inadequate quality for covering losses.

The authorities started to resolve the gaps in the international regulatory framework for banks immediately after the onset of the financial crisis, and the Basel Committee on

1. Banks' capital, i.e. their sources of funding, are divided into equity capital and debt. Equity consists of own funds of various quality, e.g. invested share capital or cooperative capital and retained earnings. Banks' debt capital includes deposits from the public as well as long- and short-term securities issued by banks.
2. Total exposure, i.e. risk-weighted assets, is calculated as the weighted sum of balance sheet values, using multipliers that are risk weights based on the estimated exposures of the assets.

Banking Supervision introduced a set of reform measures in 2010. The new rules ('Basel III') were phased in gradually in the European Union, starting on 1 January 2014. The Basel III recommendations will be implemented gradually in the EU, by means of the Capital Requirements Directive[3] and the Capital Requirements Regulation, by 2019. The purpose of the regulatory reform and the introduction of more effective and harmonised banking supervision is to improve the stability of the banking system and prevent banking crises.

Minimum requirements complemented by buffers

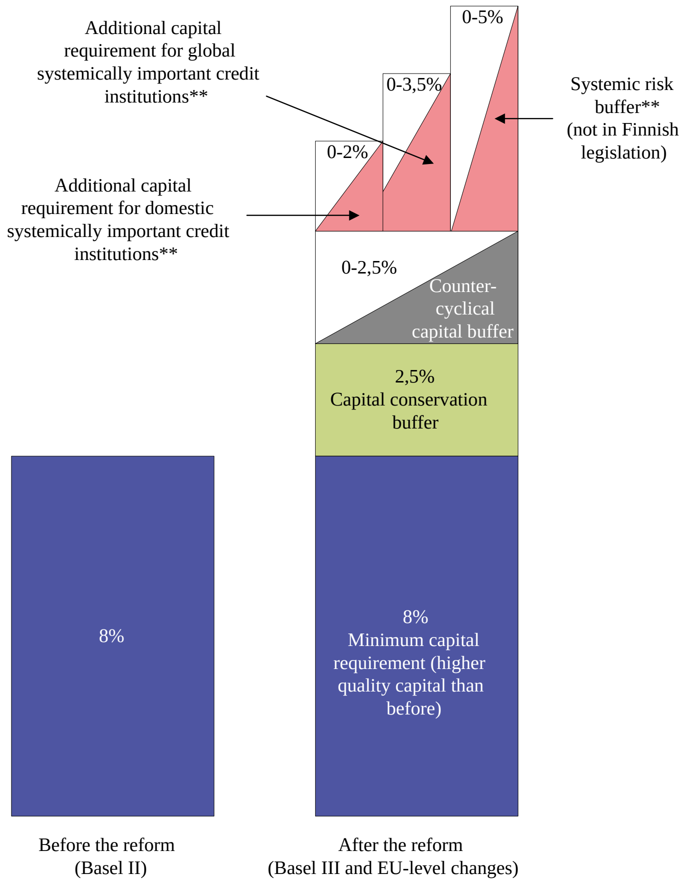
As a result of the new regulatory framework, banks are required to hold a larger amount of high-quality own funds. The minimum capital requirement of 8% relative to risk-weighted assets entered into force in 2015. Credit institutions must also fulfil the capital conservation buffer requirement of 2.5%. Authorities can also impose on banks a countercyclical capital buffer requirement to prevent systemic risk when growth or the volume of credit so requires. An additional capital buffer requirement can be imposed on global or domestic systemically important credit institutions. As a result of these requirements, the total capital requirement for banks is 10.5–16.5% of risk weighted assets.

In addition to globally harmonised minimum capital requirements and buffers, EU countries may introduce a discretionary additional capital requirement (systemic risk buffer). If the requirement is incorporated in national legislation, it can be set to cover e.g. risks caused by the large size or vulnerable structure of the banking system.

Chart

3. In Finland, the Capital Requirements Directive was transposed into domestic legislation by a new Act on credit institutions.

Old and new capital requirements for the banking sector*



*Relative to risk-weighted assets. Capital requirements reflect also the leverage ratio requirement and the Pillar 2 requirement.
**As a rule, the highest requirement is in force.
Sources: European Commission and calculations by the Bank of Finland.

The supervisory authority assesses banks' risk exposures and the adequacy of capital and liquidity, applying harmonised procedures and methodologies (supervisory review and evaluation process, SREP). The assessments also take into consideration stress testing on banks; depending on the outcome of the stress tests, the supervisory authority may impose a discretionary additional capital requirement (Pillar 2 requirement).

The higher capital requirements and the measures required as a result of tighter regulation are reflected as an increase in banks' costs. However international studies[4]

4. For example Dagher, J. – Dell'Ariccia, G. – Laeven, L. – Ratnovski, L. – Tong, H. (2016) Benefits and Costs of Bank Capital. IMF Staff Discussion Note 16/04.

show that the total benefits of tighter capital requirements are larger than the costs.

Basel III regulation is sometimes referred to as a regulatory wave. The Basel III reform is in the implementation phase, i.e. the last waves of the regulatory wave are hitting the shore. All in all, the revision of capital requirements is in its final stage, and a new regulatory wave is not in sight for the time being. What remains is the finalisation of the reform and the specification of implementation.

The Basel Committee on Banking Supervision will carry out in 2016 an impact assessment on the Basel III reform. The Committee is also committed to finalising the revision and specification of Basel III regulation by the end of 2016. The aim is that banks' capital requirements would not tighten significantly as a result of the specifications.

Specifications still required

The European Commission and the Single Supervisory Mechanism (SSM) of the euro area countries are in the process of harmonising the options and national discretions used in the application of prudential requirements. In addition, the calibration of the Basel III leverage ratio has not yet been finalised.[5] The requirement complements the risk-based capital requirements by restricting the build-up of debt by banks so that they should hold 3% equity relative to non-risk-weighted assets. Authorities are also considering an additional leverage ratio requirement on global systemically important banks.

There are differences in the determination of risk weights and banks' models for calculating them, and these differences weaken the comparability of risk-weighted assets. A bank's approach to the calculation of risk weights may have a significant impact on capital requirements. Hence, both the Basel Committee and the European Commission[6] have recently expressed an intention to harmonise the approaches to the calculation of risk weights. The harmonisation of the calculation of risk weights would support a level playing field among banks. The Basel Committee is also revising the capital framework for banks' trading books. The capital treatment of sovereign exposures is also currently subject to a global assessment.

If a bank fails and becomes subject to resolution proceedings it must have an adequate amount of assets for implementing the bail-in[7] tool. The Financial Stability Board (FSB)[8] has issued a total loss absorbing capacity (TLAC) standard for global systemically important banks that complements the capital and leverage ratio requirements imposed on the banks. The EU's Bank Recovery and Resolution Directive (BRRD) already includes a definition for a minimum requirement for own funds and eligible liabilities (MREL) applied to all banks. The TLAC is very similar to the European

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5. For example, the consultative document by the Basel Committee on Banking Supervision 'Revisions to the Basel III leverage ratio framework'. See http://www.bis.org/bcbs/publ/d365.pdf.
6. Communication from the European Commission 'Towards the completion of the Banking Union'. See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0587&from=FI
7. Bail-in means that a bank's shareholders and creditors bear primary responsibility for the bank's losses.
8. A Board operating under the auspices of the G20 countries.

MREL requirement; it is nevertheless more extensive and tighter. The objective is to harmonise these requirements on the level of EU legislation.

Financial system's resilience to shocks needs fostering

High-quality capital regulation of the banking sector is consistent and provides similar banks a level playing field. Financial system participants – both banks and investors – must also have clarity as to future regulatory changes.

The framework for the capital regulation of the banking sector is now more or less in place, even though some of the important details are still being specified. The regulatory wave will subside, but the global financial markets are in a process of continuous change. The improvement of banks' capital adequacy, in addition to other regulatory and supervisory reform, has increased the resilience of the financial system, but it is not a magic cure for removing all the risks in the system.

Vulnerabilities and risks to financial stability must be monitored and analysed carefully in future, too. In addition to globally harmonised regulation, we need national macroprudential policies for addressing country-specific systemic risks and vulnerabilities. Authorities must react, by means of macroprudential or legislative measures, if the policy stance or regulation do not correspond to changes in the financial market environment or structures.

It is important to assess and monitor the overall impact of regulation. If there are gaps in legislation or excesses, these must be amended and corrected to ensure the ability of the financial system to support sustainable economic growth.

In history, a regulatory wave has often been followed by an easing of regulation. The extensive work done to improve the financial system's resilience to shocks must not be vitiated by letting history repeat itself.

Tags

regulation, capital adequacy, banks