The New World of Basel 3

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BANGKO SENTRAL NG PILIPINAS

The Knowns and Unknowns of Basel 3

$$\text{Capital Adequacy Ratio} = \frac{\text{Capital}}{\text{RWA}}$$

- Tighter definition of bank capital
- Link capital to cyclical behaviour
- Recognize SIFIs, global and local

- Account for "new" risks
- Better price transparency … or else
- Think of correlations & stress tests

The Knowns and Unknowns of Basel 3

⬆	Capital Adequacy Ratio	***Higher value; Better Composition***
⬇	Leverage	***Less risks; More Restraint***
★	Liquidity	***Structured handling***
★	Infrastructure	***Key source of risk***
★	Price Transparency	***Back to basics***

What the reforms are not (necessarily)

- The reforms does not change the perspective of banks

Choose w_i:

Asset 1

Asset 2

Asset 3

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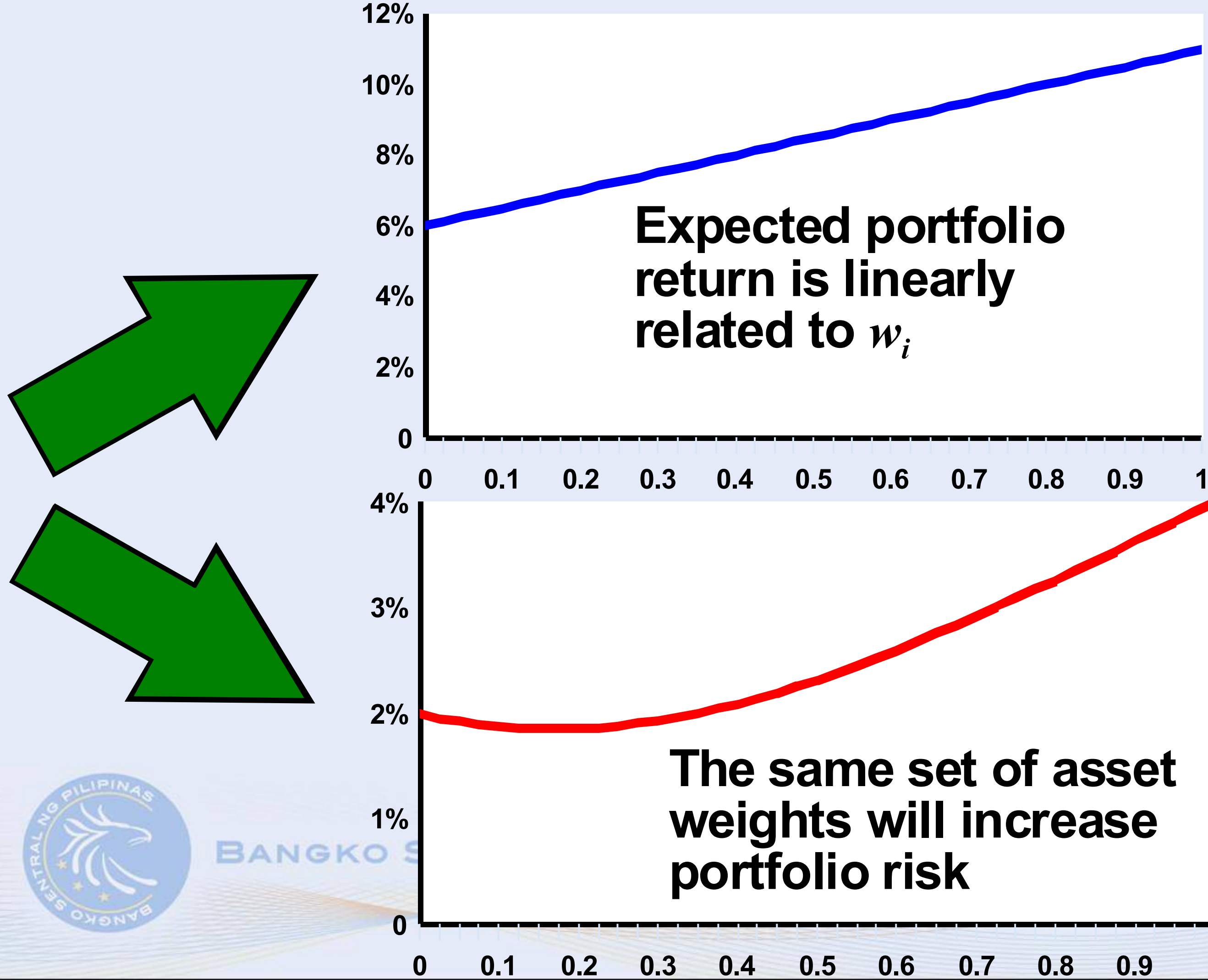
.

.

Asset n-2

Asset n-1



What the reforms are not (necessarily)

- Should not force an increase in bank capital

$$CAR = \frac{K}{RWA}$$

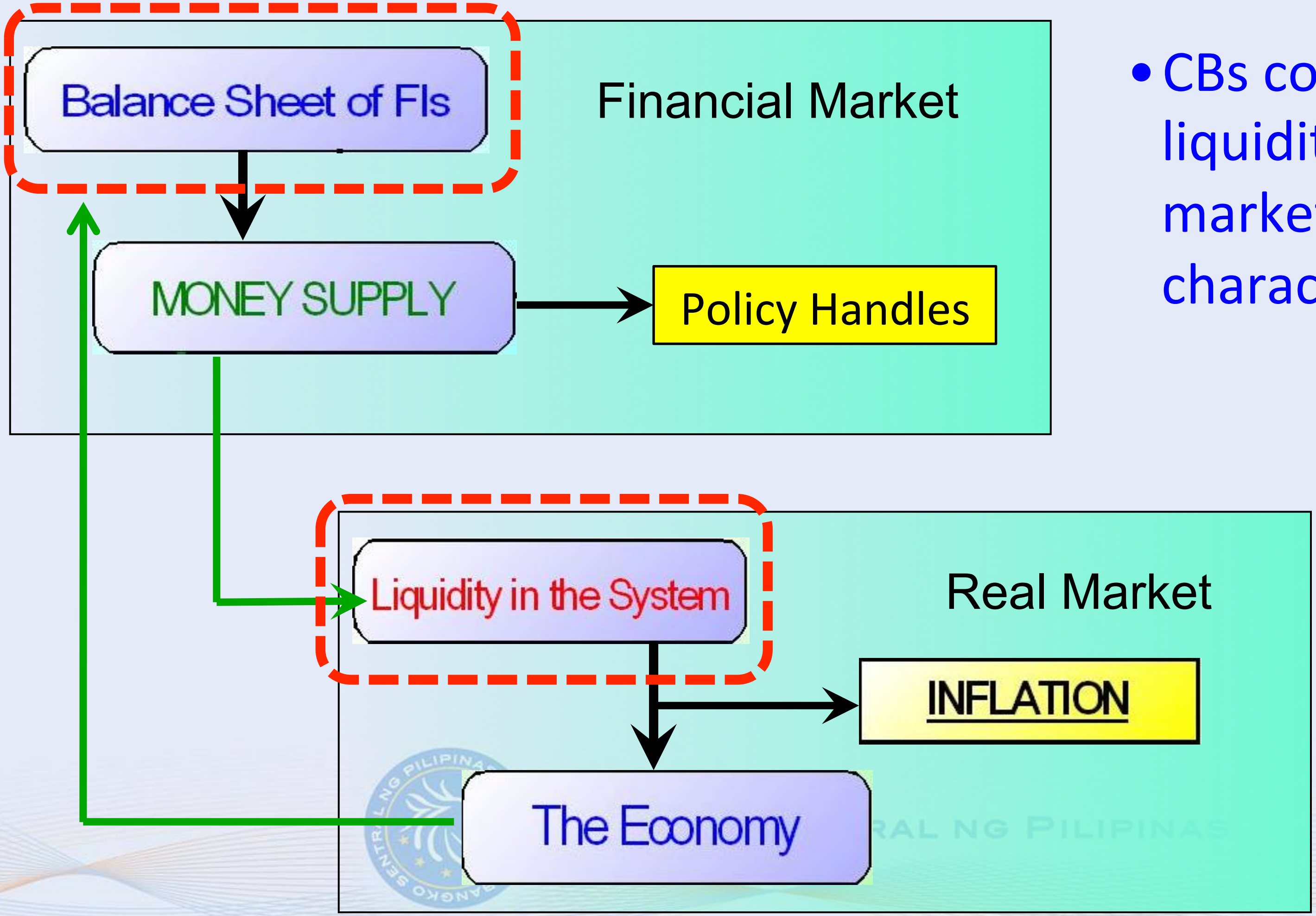
- CAR is useful because it relates owners' funds (capital) to the risks taken by the bank

$$CAR(Risk) = \frac{K_{ST}}{RWA(Risk)}$$

- CAR is not a mechanical ratio but should be more behavioural
- The key is how banks structure their RWA for a given level of K

What the reforms will do

- Brings liquidity risk to the forefront … finally



- CBs control liquidity but the market defines its character

What the reforms will do

- Inward look at infrastructure risk and risk channels

1. Wholesale and retail payments systems are getting more focus

2. Greater emphasis on price transparency is also giving market infrastructure a boost:
    a) December paper of BIS requires banks to have capital charges for exposures to CCPs
    b) More recent paper on FMI is a market-changing proposal for new best practices

What the reforms will do

- Can introduce uncertainty because of timing

(shading indicates transition periods - all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins							Introduce minimum standard	

Some banks prefer to move forward with the changes. . . But cannot

What the reforms will do

- Makes the case for better protection. . .but for whom?

1. Financial Stability is now the "new normal"
   - Stability requires some uniformity in global behaviour

2. Behaviour deemed "bad" will put stability at risk

3. This can create a conflict of interest
   a) Will jurisdictions be "saved" in line with global stability?
   b) Yet, we teach investors that they must be held responsible for their actions

HOW do we manage financial risk ?

	Assets	Liabilities
Banks	Loans Investments Provisions (Contra)	Deposits
Securities Firms	A/R (secured by securities) Investments	Payables (short position) Wholesale funding – repos – securities borrowing
InsCos	Investments	Technical provisions

Are the Standards Really So Different?

Technical Provision

- Transaction risks
- Meet obligations, current and future
- Going concern

Net Capital Rule

- Transaction risks
- Meet obligations, current and future
- Going concern

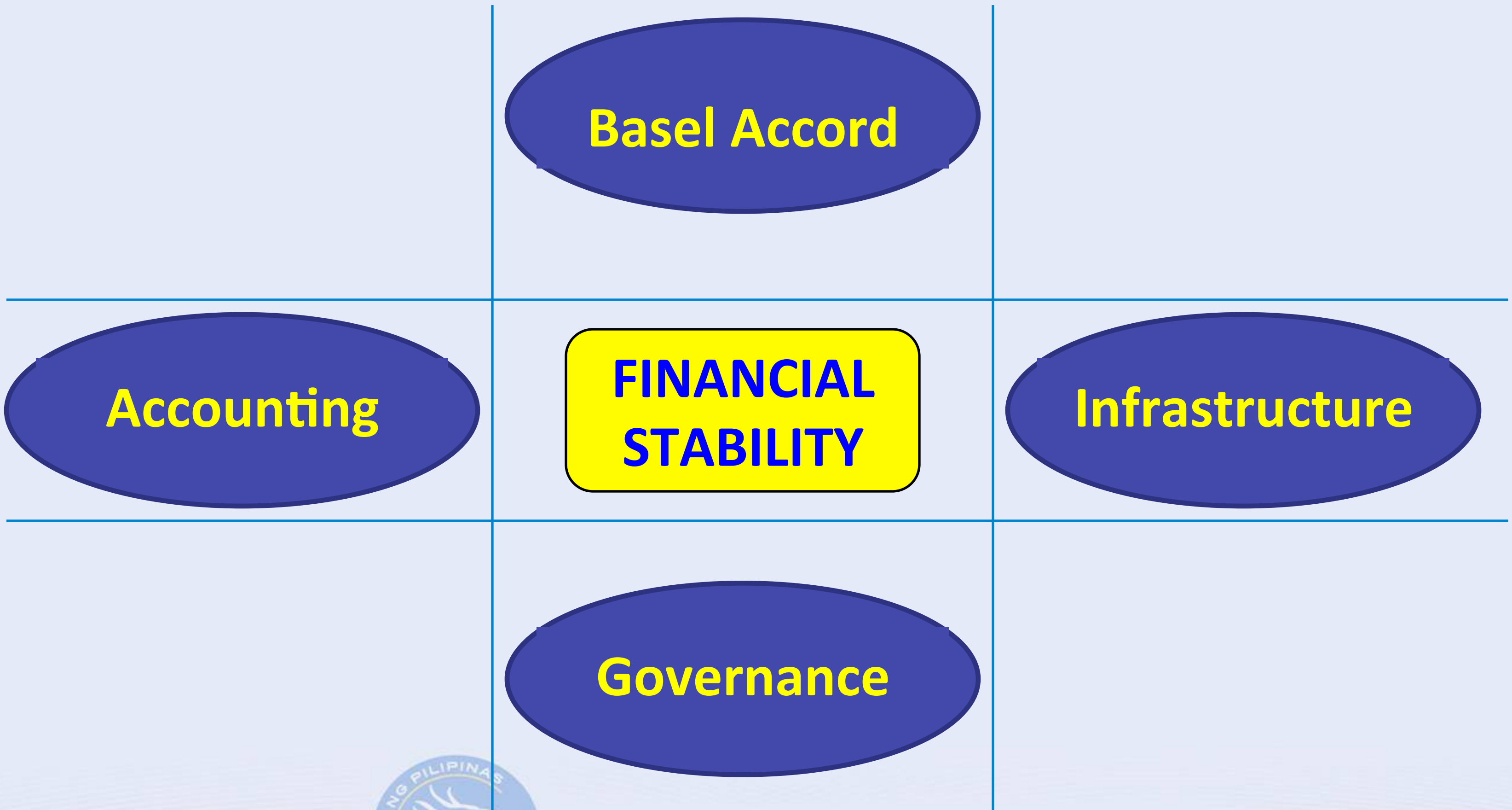
Basel 3 Framework

- Transaction risks
- Meet obligations, current and future
- Going concern

- Liquidity
- Sensitive to cycles
- Macro-prudential
- SIFIs
- FMIs

Challenges to Supervisors

- We cannot take Basel 3 independently of other reforms



Challenges to Supervisors

- Supervisors need to develop multi-faceted skills

"... it would be very useful to develop staff who have the expertise of a macro-financial economist, the preciseness of a financial engineer, the orderliness of an accountant, the eloquence of a commentator, the imagination of a physicist and the perspective of a market practitioner"

Gov. Amando M. Tetangco, Jr.
High Level BOJ-BIS Conference
Hong Kong, SAR November 2010

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