

Basel III & liquidity – Going all the way

This article draws on a discussion on Basel III during a webinar where industry experts discussed the implications of Basel capital and liquidity requirements for the banking sector

The Panel

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Basel III, which will be introduced from 2013, is setting new, much higher levels of capital and liquidity for the banking industry and poses severe challenges in terms of future business models. Capital requirements will double for some banks, and something close to €1.7 trillion more liquid assets will need to be held by European banks due to the new liquidity buffer requirements. Banks are already changing their activities, with some shedding risk-weighted assets and others withdrawing from certain capital-intensive businesses. Going forward, fee-based businesses look attractive. In addition, the introduction of two new liquidity ratios will fundamentally alter how banks manage their balance sheets and funding composition. Some banks are even considering if it will be economic to offer short-term deposit facilities. This strategic reassessment is happening at a time when the industry is also adjusting to the post-crisis environment. This is also having a significant effect on business models.

Getting the business model right will not be straightforward. There's no one-size-fits-all strategy – firms will need to assess in which markets and jurisdictions they have a competitive advantage and consider withdrawing from markets that are peripheral to their core franchise. Painful decisions are going to have to be made as banks examine their cost bases, staffing levels and funding models. The complexity of Basel III (covering changes in risk weights, new capital buffers, leverage and liquidity buffers), combined with economic uncertainty, make the number of dimensions that need to be considered in setting a new strategy large.

With requirements tightening across different jurisdictions, it has become costly to have a complex group structure. Trapped capital and liquidity will be expensive going forward. Many firms are considering rationalising their structures and some are considering having only one hub in each time zone – the US, Europe and Asia. This will reduce the need for cross-country booking and will reduce the number of entities.

In addition, the importance of local non-wholesale funding is growing because more stable retail deposits alleviate some of the costs of the new liquidity buffer and because there are continuing pressures in some wholesale markets. For example, some European banks with US operations funded on a wholesale basis are finding it difficult to raise dollar funding. This is leading to targeting of both

retail customers and a wider range of currencies for funding – for example, Singapore, Australian and Canadian dollars.

The changes in strategy are taking place against a backdrop of continuing uncertainty regarding the final rules. The Capital Requirements Directive in Basel III (CRD4) is likely to be agreed in November. Although the capital provisions are now almost final, the Basel Committee is still in the process of amending the liquidity coverage requirement (LCR), both stresses and composition of the liquid assets buffer, and also making minor changes to the leverage requirements. The composition of the buffer is controversial. High-quality equities have been suggested as a component to reduce reliance on sovereign bonds and did indeed remain liquid in the major markets even during the 1987 crash. Once the LCR has been tackled, the Basel Committee will look at the net stable funding ratio.

With funding pressures continuing and restrictions on the size of banks' balance sheets, with leverage requirements and higher capital charges, one issue is whether the authorities should do more to encourage the formation of a simple high-quality securitisation product. This would enable deleveraging while not damaging credit creation. One carrot the authorities could offer is allowing the new instruments into the liquidity buffers and into central counterparties.

The challenges for the industry go beyond strategy and also include implementation. Collateral management, counterparty risk and credit valuation adjustments are all major data/systems exercises for banks. Liquidity reporting and management also poses huge systems and data challenges. One question for European banks is whether the delay in agreeing CRD4 will make implementation timelines difficult to achieve. The experience of banks in the UK, the US and Canada, which met more extensive liquidity reporting requirements earlier than Basel III, was that data aggregation, collecting data on contractual cash flows and collateral tracking were all significant challenges.

One issue for all banks is whether the right tools are in place to support the complex strategic decisions being made. Finance models were not designed to optimise the strategy across capital, leverage and liquid assets. Other complex decisions are raised by ring-fencing or Volker-type rules. New tools will be needed for the new environment.



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To view and listen to the full proceedings of the *Risk Basel III and liquidity* webinar, visit www.risk.net/2208557