Changes to regulations and the evolution towards Basel III
May 2015

In 2011, the Central Bank of Argentina (BCRA) published a roadmap for the implementation of the banking regulation scheme commonly referred to as Basel III. Four years later, it is convenient to make a short retrospective and list those measures that should be implemented shortly to keep our regulatory framework within the terms agreed upon at different international fora.

In this regard, it is of interest to note that in 2008, during the meeting held in Washington, G20 leaders pledged themselves to make a fundamental reform of the global financial system, in order to correct the flaws that had led to the global crisis and to build a system more secure and useful to the needs of the real economy.

Since then, the Basel Committee on Banking Supervision (BCBS) have started work to reformulate the regulatory framework then effective, focusing on the "International Convergence of Capital Measurement and Capital Standards", the agreement usually referred to as Basel II.

There were two stages. The first one—ended by mid-2009 and known as Basel 2.5—consisted of a set of measures aimed at strengthening the three pillars of Basel II, especially, those rules regarding market risks and securitizations. The second stage, referred to as Basel III, is an integral reform of the regulatory framework. The main elements were disclosed in late 2010 but its implementation is still undergoing development.

The purpose of this reform is to increase financial institutions' capacity to face disruptions created by financial and economic turmoils, by improving regulation, supervision and risk management in the banking sector. Basel II capital requirements are raised and standards on liquidity and measures for macroprudential supervision are introduced for the first time.

Implementing these measures in full and within the agreed timeframe is considered pivotal for a sound and adequate operation of the banking system and to promote economic recovery and sustainable growth. To that end, G20 leaders have continuously expressed their commitment to the reform of the financial regulatory framework. Before the publication of the Basel III final text and during the Seoul summit in November 2010, they further committed to implementing the capital and liquidity standards of the Basel Committee in their jurisdictions. Then, in Cannes, in November 2011, they reiterated the need to adopt the provisions of Basel II and Basel 2.5 and the commitment to implement them in a full and homogeneous manner as well as to introduce Basel III as from 2013. In the summit held in Brisbane in November 2014, G20 leaders welcomed progress made and set as the priorities for the next work stage the rapid, full and consistent implementation of the reforms agreed upon and the completion of those still pending, focused on three key areas—banks' capital framework; measures to facilitate the resolution of too-big-to-fail institutions, and the initiatives to make the derivatives market more secure.

BCRA's response

In line with the commitments made and in accordance with the terms and the schedule contained in the roadmap of 2011, the BCRA has implemented the following provisions:

Capital

In 2012, the basic indicator approach of Basel II was adopted to determine the capital requirement for operational risk[1]. Provisions on credit risk and eligible capital[2] were set forth in 2012 to become effective as from January 2013. In order to determine the requirement for credit risk, the standardised approach was adopted, including improvements introduced by Basel 2.5 and Basel III. The risk weight mechanism of the standardised approach—based primarily on external ratings—was replaced by a risk-weight table that, still keeping the minimum coverage requirements of Basel II, avoids automatic references to rating agencies in our regulation, as recommended by the Financial Stability Board (FSB). Regarding eligible capital, the minimum coverage ratios and the definition of capital of Basel III, which are more stringent than those of Basel II, were incorporated to our regulation. Consequently, Common Equity Tier 1 capital (common shares), Additional Tier 1 capital (preferred shares) and Tier 2 capital (subordinated debt subject to write-offs or conversion to common shares) shall be issued in such a way that common equity, Tier 1 and total capital cover 4.5%, 6%, and 8% of risk-weighted assets, respectively.

Pillar 2 requirements, which refer to the supervisory review process, were incorporated in May 2011 and February 2013 to the risk management guidelines for financial institutions[3], which currently comprise guides for the management of risks related to credit (including counterparty credit risk), liquidity, markets, interest rates, operations, securitizations, concentrations, reputation and strategy, and also guides for the execution of stress tests. The risk management guidelines and the information requirements on business models are the basis for the institutions' capital adequacy self-assessment (Internal Capital Adequacy Assessment Process, ICAAP) and for the subsequent revision by the SEFyC (Supervisory Review and Evaluation Process, SREP). To this end, financial institutions have to implement a comprehensive internal process to assess the adequacy of their economic capital vis-à-vis their risk profile and also establish a strategy to maintain their capital level over time.

Pillar 3 requirements (market discipline) outline the minimum information that should be published so that market participants may assess financial institutions' liquidity, solvency and risk management. In February 2013, it was provided that institutions should post qualitative and quantitative information on their websites as from December 31, 2013, following the standards established by Basel II and Basel III[4].

[1] Communication "A" 5272.
[2] Communication "A" 5369.
[3] Communications "A" 5203 and "A" 5398.
[4] Communication "A" 5394.

Additional capital requirement for domestic systemically important financial institutions

In the Cannes summit of 2011, G20 leaders approved both the Committee's methodology intended to identify Global Systemically Important Banks (G-SIBs) and the capital requirement—in addition to that of Basel III—aimed at increasing their capacity to absorb losses. In the same meeting, they requested that the Committee and the FSB extend such regulatory framework to Domestic Systemically Important Banks (D-SIBs) as, just like G-SIBs, they may cause unwanted effects upon the rest of the economy, particularly where large banks with a high level of interconnectedness become insolvent.

In 2014, the BCRA published the "Methodology to Identify Domestic Systemically Important Banks". Subsequently, in January 2015, it published an additional requirement for these institutions, which equals 1% of their risk-weighted assets to be fully met with Common Equity Tier 1 capital, and which will be phased in between January 2016 and 2019[5].

Leverage Ratio (LR)

The LR is defined as the ratio between Tier 1 capital and total assets. The build-up of excessive leverage—which was not impeded by risk-based capital requirements—was one of the underlying causes of the global financial crisis and then, the subsequent sudden reduction in the level of assets, one of the pressures that contributed to its amplification. Therefore, Basel III introduced this new and simple measure, independent from risk weights, to supplement capital requirements that are risk-based.

As from the first quarter of 2015, financial institutions will be required to report on their leverage ratios in accordance with the minimum disclosure requirements established to promote market discipline[6]. By January 2018, this ratio will become a mandatory requirement, with a minimum that has not been internationally agreed upon yet (presumably, 3%).

Liquidity Coverage Ratio (LCR)

In order to prevent banking illiquidity in stress scenarios from affecting the real economy, financial institutions should have at all times an adequate stock of unencumbered high-quality liquid assets (HQLA) that allows them to meet their short-term liabilities. These assets must also be easily convertible into cash in the capital market. The ratio between liquid assets and the expected cash outflow should not be less than one; however, a lower ratio will be acceptable during stress periods on grounds of a bank's need to meet payments.

As from January this year, the BCRA has enforced the LCR for large institutions (Group "A") according to a timetable provided for in Basel III; i.e. an initial compliance amounting to 60% of the LCR that progresses to full compliance of the requirement in 2019[7]. In addition, it has recently released a list of liquidity risk monitoring tools[8].

[5] Communication "A" 5694.
[6] Communication "A" 5674.
[7] Communication "A" 5693.
[8] Communication "A" 5733.

These tools are a set of metrics related to cash flows, balance sheet structure and available unencumbered assets, all of which will allow the SEFyC to better monitor financial institutions' liquidity risk.

Looking ahead

The BCRA has implemented almost all the international commitments related to Basel III due in the short-term. Nevertheless, it is still necessary to redefine part of the current regulation and address certain supplementary aspects to conclude this first stage. Without any doubts, the greatest challenge for financial institutions will be the proper implementation of the new framework and its integration into their risk management. The BCRA and the SEFyC must work too to properly incorporate the new tools to the monitoring cycle. Here is a brief overview of the regulation to be changed or introduced in the short-term.

Capital

The chapter on credit risk will soon include a specific capital requirement for financial institutions' exposures to clearinghouses or Central Counterparties (CCPs), still missing in our regulation. Upon the implementation of the standard, exposures resulting from derivatives—whether traded in institutional markets or not—and Securities Financing Transactions (SFT) will be subject to capital requirements. These requirements will depend on the type of exposure and the nature of the clearinghouse. Along the same lines, capital requirements for market risk will also be updated to incorporate more stringent rules for derivatives and illiquid positions.

Capital Conservation Buffer

As from January 2016, financial institutions will be required to hold Common Equity Tier1capital, in addition to the Basel requirement, for up to 2.5% of their risk-weighted assets. Implementation will be phased in until January 2019. In case of failure to meet this new buffer, dividend payments will be limited.

Countercyclical Buffer

This is a macroprudential measure that seeks to prevent excessive credit growth and bubble formation. The BCRA will soon disclose the conditions that shall determine, starting in 2016, the release from, or gradual compliance with, this buffer, which shall vary from 0% (during periods of contraction) to 2.5% (during periods expansion) of risk-weighted assets.

Intraday Liquidity

In order to complement the supervision of short-term liquidity, the BCRA will soon release a set of tools for the monitoring of financial institutions' management of their intraday liquidity.

Net Stable Funding Ratio (NSFR)

The final text of this standard was published by the Committee in October 2014. However, the rate will become a minimum requirement in January 2018. In order to comply with this standard, financial institutions will be required to have funding sources consistent with the liquidity of their assets. This is to limit overreliance on short-term funding, particularly from the wholesale market.

In the short-term, the BCRA will continue to monitor the NSFR performance through a sample of banks.

Risk Management and Increased Intensity of Supervision for DSIBs

The BCRA will add to its risk management guidelines the "Principles for Effective Risk Data Aggregation and Risk Reporting" published by the Committee in January 2013. The objective of this set of principles is to promote the implementation of adequate policies for data aggregation in financial risk management systems and the corresponding improvements in information technologies. As the first step, those institutions that the BCRA identifies as DSIBs will be required to implement the principles within three years following the date on which they may have been identified as such.

Roadmap for the Convergence of Reporting and Accounting Systems to IFRS

In February 2014, the BCRA published the roadmap for the implementation of the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB)[9]. The convergence plan for financial institutions, which will end in January 2018, will improve consistency between financial institutions' balance sheet data and the relevant chapters of Basel III. In particular, conciliation with the disclosure requirements on capital, liquidity coverage ratio and leverage ratio will be made easier.

The changes announced in this roadmap are just those necessary to put into practice the most essential Basel III reforms. There are issues regarding implementation that have not yet been determined in the international fora and other reforms of standards and financial infrastructures that fall outside the remit of Basel III and even of the liquidity and solvency standards applicable to the banking system.

The BCRA will continue to work with the aim of bringing local regulations in line with international best practices, without losing sight of the intrinsic characteristic features of the Argentine economy and the need to promote domestic investment and consumption.

[9] Communication "A" 5541.