

Changes to Standards and Progress towards Basel III

In 2007 the Central Bank of Argentina (BCRA) published its road map for the implementation of the capital adequacy requirements contained in the document entitled “International Convergence of Capital Measurement and Capital Standards”, issued by the Basel Committee on Banking Supervision (BCBS) and better known as Basel II. The first stages were carried out as planned: publication of best practices for risk management, seminars, review of supervision processes on the basis of the best practices being encouraged by the BCBS, analysis of the areas subject to “national discretion” in the calculation of regulatory capital, and publication of the ordered text of the “Guidelines for Operational Risk Management in Financial Institutions”. At the same time, the international financial system was beginning to deteriorate, which became evident in the United States with the sub-prime lending crisis that started in 2007 and spread to other countries in 2008 and 2009.

More demanding financial regulations

The international response to the crisis has been to review standards, basically in the banking sector, and coordinate efforts to achieve convergence of the regulations applicable in each country. In response to a request from the G20 leaders, national supervisors, the Financial Stability Board (FSB) and the BCBS, together with other issuers of international standards for voluntary adoption, have carried out a survey of the deficiencies that influenced the development of the crisis. Working groups set up with this aim detected numerous weaknesses in financial regulation and have drafted proposals for incorporation to national rules in the short and medium term.

Specifically, in December 2010 the BCBS published a set of measures known as Basel III, designed to increase the capacity of the system to absorb shocks from stress situations and improve risk management and the transparency of bank disclosures. Unlike Basel II, the new standards not only measure risks at the level of each financial institution, but they also contain a macroprudential component, with the aim of determining the impact that risk accumulation and contagion might have at the level of the entire financial system. The BCBS defines Basel III as a comprehensive set of reforms, designed with the aim of improving the resilience of the financial sector to disturbances caused by situations of financial and economic stress. The publications making up this set of rules can be consulted on the BCBS website.¹

¹ http://www.bis.org/bcbs/basel3_es.htm

Basel III

Basel III is a set of standards concerning the solvency and liquidity of financial institutions. To begin with, it incorporates the terms of Basel II, which are contained in three “pillars”. Basel II’s Pillar 1 provides supervisors with a number of options to quantify capital requirements for credit, operational and market risk, at the same time as defining which components of an institution’s net worth are eligible to satisfy that requirement. Pillar 2 describes the process to be followed by institutions to evaluate the sufficiency of their capital in relation to their risk profile—*Internal Capital Adequacy Assessment Process*, (ICAAP)—and the review of such evaluation to be made by the supervisor—*Supervisory Review and Evaluation Process*, (SREP). To encourage market discipline, Pillar 3 establishes minimum information requirements that financial institutions must provide on the adequacy of their capital.

In its road map on the way to Basel II published in 2007, the BCRA had announced its choice of the Simplified Standardised Approach to measure credit risk, while delaying a decision on operational risk until it could identify the most appropriate measurement mechanism for the local financial system. It had also been announced that existing mechanisms for calculating market risk and interest rate risk capital requirements would be maintained.

Since then, however, and in response to the international crisis, the BCBS has made a series of modifications to Basel II. In July 2009, adjustments were made that mainly affect the proposed treatment for market risk and securitisation. At the end of 2010, together with the new ratios established by Basel III, more significant changes were made to the Basel II framework: a more conservative treatment was laid down in relation to the instruments accepted for capital compliance, and improvements were made in the treatment of credit risk to ensure a better level of capitalisation.

Minimum Capital

Since the introduction of Basel I, financial institutions in the jurisdictions that adopted it must keep total capital at not less than 8% of their risk-weighted assets. Items going towards compliance with this capital requirement are classified in two groups: core capital (Tier 1) and supplementary capital (Tier 2). According to Basel II, at least half the capital requirement should be composed of core capital, preferably common equity, a category that includes common shares and retained earnings.

Basel III establishes more demanding requirements, as banks must comply with three minimum ratios in relation to their risk-weighted assets: 4.5% in the case of common equity (for which qualifying criteria are more restrictive than for Basel II), 6% for Tier 1 capital, and 8% for total capital. This new capital composition ensures there will be greater capacity to absorb losses in stress situations, because whereas the holders of instruments making up Tier 2 (basically subordinated debt issues) only suffer losses in the event of the liquidation of a financial institution (a “gone concern”), the holders of the instruments making up Tier 1 are exposed to losses even when the institution is still operating (a “going concern”).

It should be noted that although international standards foresee a gradual introduction of these three requirements as from 2013, in Argentina the average current composition of financial institution net worth ensures that the total requirement can be met out of common shares and reserves. At system level, common equity is equivalent to 12.33% of credit risk weighted assets, coverage well in excess of the total Basel III requirement².

Capital Conservation Buffer

The so-called capital conservation buffer imposes an additional requirement equivalent to 2.5% of risk-weighted assets that must be met by common equity. The purpose of this is to be able to count on sufficient reserves to absorb additional losses generated at times of economic and financial stress. In fiscal years in which common equity is less than 7% of risk-weighted assets (the 4.5% requirement plus the new conservation buffer), rising constraints are established for financial institutions, which will not be able to pay out dividends, award discretionary bonuses or perform share buybacks. This additional buffer will be introduced gradually as from 2016, and will be fully in effect as from 2019.

In Argentina the financial system operates with a considerable capital excess. Furthermore, the current system for the retention of earnings (Ordered text on Profit distribution³) leads to a capital integration excess, measured in term of risk-weighted assets, of slightly over 2.5%.

Countercyclical Capital Buffer

The aim of the countercyclical capital buffer is to offset the procyclical nature of the financial system. In times of exceptional credit growth at aggregate level, financial institutions will be required to boost the level of their common equity by up to 2.5% of risk-weighted assets. Like the

² Estimated on the basis of information at July 2011.

³ <http://www.bcra.gov.ar/pdfs/texord/t-disres.pdf>.

capital conservation buffer, the countercyclical buffer will be introduced gradually as from 2016, and will be fully in effect as from 2019.

Leverage Ratio

As experience has shown that risk-based measures are insufficient to preserve financial institution solvency, Basel III complements risk-weighted asset capital requirements with a limit on total leverage. This limit, known as the leverage ratio, is the ratio between core capital (Tier 1) and total assets without risk weighting, both on and off balance sheet, plus derivatives. At international level, this ratio has initially been set at 3%. This new limit will begin to operate as from its incorporation to Pillar 1 in 2018. In Argentina, financial institutions record a lower leverage than the proposed maximum. The average ratio for the system is 7.09%, although this figure is determined by the assumptions adopted regarding a series of data not currently disclosed on bank balance sheets⁴. Calculations will be refined during the process of convergence with international standards by means of an information regime better suited to the required information.

Although Basel II establishes a capital requirement for the market risk generated by foreign currency positions, no cap is placed on them. On the other hand, Basel III introduces a limit through the leverage ratio, set in relation to total exposure regardless of the currency in which the assets are stated. Mismatches between asset denomination and the currency in which the ultimate borrower receives its income are not taken into account, except indirectly, when listed among the risks to be included in Pillar 2 on credit concentration risk, understood as the presence of common or correlated risks within the loan portfolio. This Central Bank has repeatedly raised the importance of dealing with currency mismatching explicitly. Based on our experience, Argentine regulations limit direct exposure to currency risk (Ordered text on Global Net Foreign Currency Position⁵). Furthermore, with the aim of preventing the indirect exposure generated by the granting of loans denominated in foreign currency to agents whose income is in pesos, regulations in Argentina only allow funds obtained from deposits in foreign currency to be lent to customers who generate income in the same currency (Ordered text on Lending Policy; Section 2, Application of Lending Capacity from Deposits in Foreign Currency⁶). Therefore, those receiving loans in foreign currency are those whose income is directly or indirectly generated in that same currency.

⁴ Estimated on the basis of information at July 2011.

⁵ <http://www.bcra.gov.ar/pdfs/texord/t-pognme.pdf>.

⁶ <http://www.bcra.gov.ar/pdfs/texord/t-polcre.pdf>.

Macroprudential Supervision

The reforms introduced by Basel III have two objectives. One is more traditional, designed to ensure that individual banks can show resilience in periods of stress, which since the crisis has begun to be described as “microprudential”, and the other, complementary and broader, seeks to discourage the building up of risks across the banking sector, as well as their procyclical amplification. The so-called countercyclical capital buffer is included within the latter, but it also contains other regulations that have already been published, and some that are in the preparation process. In this area, in the case of measures to limit banking system currency mismatches as described in the previous point, it should be mentioned that as part of its “macroprudential” policy Argentina has introduced a mandatory 30% reserve requirement on short-term funds from abroad that are not intended for direct investment. The ultimate aim of this regulation—established by means of Decree 616 in 2005⁷, Resolution 365 issued by the Ministry of Economy and Production in the same year⁸, and Communications “A” 4359, 4377, 4386, 4711 and 4762⁹ issued by the BCRA—is to prevent the forming of bubbles generated by speculative short-term capital inflows.

Liquidity Coverage Ratio

The liquidity coverage ratio (LCR) is based on the methodologies used by international banks. It will be calibrated so that financial institutions can tolerate stress scenarios over a thirty-day period. This means that banks will need to have sufficient high-quality liquid assets so as to offset net cash outflows over the following thirty days. To do so, they must determine the expected cash inflows and outflows in stress scenarios, according to predetermined renewal rates of liabilities that contemplate the greater or lesser degree of stability of each source of funds. This initiative will take effect as from January 2015.

Once again, requirements in force for our own financial system (Ordered text on Minimum Cash regulations¹⁰) are stricter than those established by the international standard. They are calculated on the monthly average of daily balances of sight and term deposits and other liabilities from financial intermediation, and current account overdrafts that banks cannot

⁷ <http://www.infoleg.gov.ar/infolegInternet/anexos/105000-109999/106969/norma.htm>.

⁸ <http://www.infoleg.gov.ar/infolegInternet/anexos/105000-109999/107422/norma.htm>.

⁹ <http://www.bcra.gov.ar/pdfs/comytexord/A4359.pdf>;

<http://www.bcra.gov.ar/pdfs/comytexord/A4377.pdf>;

<http://www.bcra.gov.ar/pdfs/comytexord/A4386.pdf>;

<http://www.bcra.gov.ar/pdfs/comytexord/A4711.pdf>;

<http://www.bcra.gov.ar/pdfs/comytexord/A4762.pdf>.

¹⁰ <http://www.bcra.gov.ar/pdfs/texord/t-efemin.pdf>.

suspend at their discretion. Liquidity requirements can reach 20% of liabilities, depending on the type of liability covered and its residual term to maturity. Liquidity reserves must be held in the currency in which the corresponding liabilities are denominated, so as to mitigate pressure on the exchange market during stress periods.

Net Stable Funding Ratio

The net stable funding ratio (NSFR), on the other hand, will be calibrated on the basis of long-term liquidity and structural mismatching in the composition of sources of funding. The design of the NSFR is based on net liquid assets and liquid capital methodologies used by internationally active banks. Banks should hold sufficient stable sources of funding (net worth and long-term liabilities) to fund the proportion of their assets that they cannot monetize within a term of one year. The NSFR will come into effect as from January 2018.

Intensive Supervision of Systemically Important Institutions

The FSB and the BCBS are working on the design of an appropriate regulatory framework for global systemically important financial institutions (G-SIFIs). Alternatives being evaluated include setting more demanding capital requirements than those foreseen by Basel III. To do so, there will be a need to agree on a method for the identification of the institutions that would be included within the G-SIFI group, and the volume of additional capital they would need to ensure a greater loss-absorbing capacity.

Towards Basel III

In line with the commitments assumed, the BCRA has been working on the implementation of the terms of Basel III, adapting them to take into account the particular conditions in emerging countries, experience gained from the financial and banking crises suffered by Argentina, the characteristics of our financial system and current legislation.

In May this year the BCRA returned to its preparatory work for the implementation of Basel II. Those stages that had already been fulfilled concerning the disclosure of risk management best practices, review of supervision processes, analysis of areas subject to “national discretion” and the issue of Communications “A” 4793 and “A” 4854 containing the “Guidelines for Operational Risk Management” were supplemented by the issue of Communication “A” 5203 with the “Guidelines for Risk Management in Financial Institutions” and systemic impact tests in relation to the adoption of standardised approaches for the calculation of credit and operational risk capital requirements.

As the next stages will require active participation by financial institutions, a schedule is submitted for public consideration that, while not neglecting the current legal framework and the priorities and circumstances of our financial system, will make it possible to introduce the Basel III standards within the periods proposed by the international financial community.

According to the plan outlined by the Board of the BCRA, during the remainder of the year surveys and consultations with financial institutions will be used to adjust the estimated impact from changes to the credit risk requirement. Analysis of the responses will make it possible to select the best solution for the Argentine financial system from the approaches available and the options subject to national discretion.

In the next twelve months, standards will be published for Pillar 1 operational risk and credit risk (except as regards securitisation, which in Argentina is considerably less significant than in developed countries), and a parallel calculation will begin to be made of the requirements, calculated according to both new regulations and current ones. The capital requirement for credit risk derived from securitisations is a new development since Basel I. By means of Communication "A" 2703 and its supplementary regulations, the BCRA has established a system for the setting up of provisions for the various types of security and equity certificates. This provision is based on the loss from expected uncollectability. Adoption of Basel II implies that banks should, in addition, hold reserves to confront unexpected losses. According to the schedule that has been outlined, capital requirements applicable to securitisations will be published at the end of 2012, when parallel calculation of the requirement will begin.

Although information regimes for supervision and disclosure establish wide-ranging and detailed information requirements, adoption of Basel II implies evaluating whether there are additional information requirements. This process has already begun, and will be open to participation by financial institutions during the coming year, with the aim of completing the minimum disclosure requirements under Pillar 3 of Basel II towards the end of 2012.

In addition, during the course of 2012 activities will take place to promote and spread information about the procedures regarding the evaluation of financial institution capital adequacy. Publication of ICAAP standards and SREP pilot tests will take place as from 2013, the year in which implementation of the Basel III will begin to take place, unless the international agenda is modified. These activities will be additional to the observation and supervision of leverage and liquidity that should be carried out during the rest of this year and next year.

In more general terms, it needs to be taken into account that the international financial crisis did not take place solely because of defects in financial regulation or shortcomings in its implementation, but also and principally because the financial sector took on volumes and risks that were disconnected from the progress of the real economy, often channelled through financial intermediation and liquidity-creating markets and institutions outside all regulation. For this reason, in addition to establishing a more demanding regulatory framework, Argentina considers that new regulations on financial matters must necessarily be accompanied by a macroeconomic proposal that favours balanced and inclusive economic development, as the financial development processes of recent decades have been accompanied by processes for the concentration of wealth and social inequality that were the effective origins of the international financial crisis.

In this context, in recent years the Argentine authorities have taken measures that not only contemplate the initiatives on liquidity and solvency in the new Basel standards—that Argentina already satisfies and exceeds—but are also grounded in the experience of our own financial system, promoting initiatives such as the restricting of unlimited speculative short-term capital inflows and the minimizing of currency mismatching.

The incorporation of international standards for asset and risk measurement will therefore serve to ensure the BCRA continues with its regulatory and supervisory activity designed to encourage credit for production and investment, accompanying a macroeconomic model intended to achieve growth and social inclusion.