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Understanding the Basel III Framework

Basel III is the response to the deficiencies of Basel II, not as a replacement but a more robust and deeper complement

Journey to Basel III

The Global Financial Crises of 2008-2009 which resulted in unprecedented losses and almost total collapse of the world financial system called for a critical rethink of risk management practices which hitherto were based on the Basel II Accord. The Accord was found to be deficient in its approach to: **capital, systemic risk and liquidity framework**. These deficiencies can be broken down to seven components as follows:

Capital

- Capital base lacked transparency, loss absorbency and was insufficient
- Excessive on-and off balance sheet leverage
- Inadequate risk coverage

Liquidity

- The believe of indefinite and permanent liquidity was untrue
- Generally insufficient liquidity buffer
- Low level of and quality of bank's liquidity buffers

Systemic Risk

- Little consideration for systemically significant institutions and the inter-connectedness / correlations among institutions
- Excessive focus on revenues and short term expectations
- Lack of consideration for economic cycle and pro-cyclical deleveraging

Basel III is the response to the deficiencies of Basel II, not as a replacement but a more robust and deeper complement. It is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision (BCBS) to strengthen the regulation, supervision and risk management of the banking sector. It is expected to:

- Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- Improve risk management and governance
- Strengthen banks' transparency and disclosures.

The reforms target:

- Bank-level, or micro prudential, regulation, which will help raise the resilience of individual banking institutions during periods of stress.
- Macro prudential, system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.

Features of Basel III

Implementation of Basel III started globally in January 2013 and is expected to be completed in 2018. Beyond capital adequacy which is the primary focus of Basel II to ensure financial soundness, Basel III in addition to capital places great importance on liquidity which evaporated during the crisis and the impact of economic cycles on financial system risks. Changes to the Basel II Accord featured in Basel III include:

- The quality of the regulatory capital has been effectively raised from 8% of risk weighted assets under Basel II to 10.5% in Basel III, with more emphasis and preference for Common Equity expected to be 7%.
- Various aspects of the regulatory–driven risk management practice have been raised, both qualitatively and quantitatively

- Introduction of a new overall maximum leverage ratio 3% of capital to risk exposure
- New measures to prevent pro-cyclical effects such as delay in paying dividends in the prosperous years
- Systemic risks and the interconnectedness have been addressed by having specific requirements for bank considered systemically significant.
- New global liquidity standard has been introduced to address both short term and long term liquidity requirements. These are captured in the Liquidity Coverage Ratio (LCR) for 30 days requirements and the Net Stable Funding Ratio (NSFR) to cover long term liquidity in a 356 days horizon

Basel III is not a panacea, and may not alone restore stability to the financial system and prevent future financial crisis

The Implications

Basel III is not a panacea, and may not alone restore stability to the financial system and prevent future financial crisis. The implications of Basel III are systemic, operational and tactical. They include the following:

a. Due to better controlled leverage and liquidity, banks will be stronger, more resilient and safer.
b. The returns as given by ROE and other measures will be lower but the cost of borrowing may also drop.
c. With lower returns coupled with the loss of confidence in the banking sector, investors have to accept a new paradigm and tradeoff of returns for safety. Lower return may impact ability to raise fresh capital required under Basel III.
d. Greater financial industry stability achieved under Basel III will allow investors to focus more on financial institution risk and worry less about the economic backdrop or the possibility of broad-based financial collapse.
e. The IT risk systems of banks will entail more granular data needs to meet risk management, increased compliance and reporting requirements.
f. There will be improved governance and oversight by the board relating to risk and capital matters.
g. Better understanding and pricing of risk as well as a more effective allocation of capital and resources.
h. Enhanced disclosure requirements and transparency.
i. Increased need for capacity building at all levels including regulators and Board.

Basel III in Nigeria

Given the international regulatory response to the global financial meltdown, the on-going reform of the Nigerian banking sector on risk management, reporting and corporate governance, and implementation of Basel II/III has become imperative. The CBN recently issued a New Regulatory Framework for Prudential Supervision of Nigerian Banking System. It is an exposure draft and regulatory guideline on the adoption of Basel II /III in Nigeria. This directive which has been long awaited by the banks triggered most banks to action to start considering options and strategies to comply. From our experience, the cost, time, resources, expertise and the implementation process could be very significant and prone to risks if not done right.

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