Banking regulation – Basel IV and all that

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IN CASE OF TOO BIG TO FAIL BREAK GLASS
LONDON ELECTRONICS SHOPPE
BANKS
YE OLDE BIGGE SCREEN TELLY

By Mike Smith, Las Vegas Sun, for USA TODAY

Agenda

1. Why are banks regulated?
2. Where do the rules come from?
3. A new regulatory landscape – response to the 2008 crisis
4. Basel IV – Review of the Credit Risk Framework
5. Challenges for the Economist

Why are Banks regulated ?

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Banks are key to the functioning of the real economy !

1. Banks perform **maturity transformation** when they transform savings into investments.
   Borrow large amounts of money from household via deposits and give long-term loans

2. Banks help **create liquid assets out of illiquid assets** via repackaging/securitising loans
   Obvious examples are issuance of covered bonds and MBS

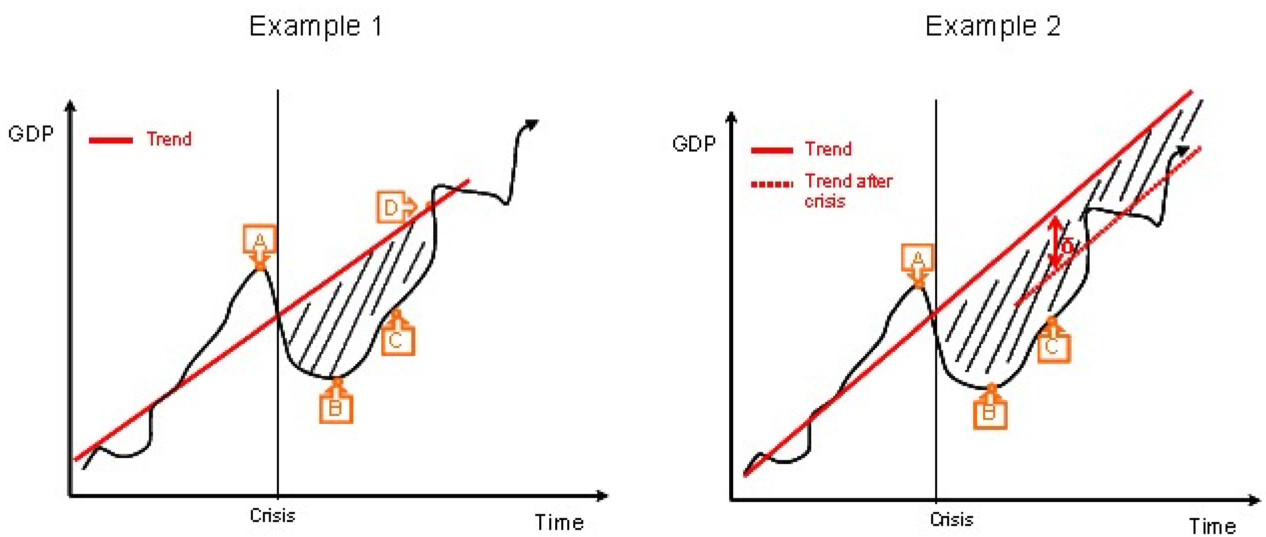
3. Banks help **reallocate interest , credit and FX risk across the economy** via markets
   Examples: bond market-making and participation in derivatives markets

4. Banks help economic actors **reallocate cash/money across the economy**
   Via central bank and inter-bank money markets

5. Banks facilitate **Government borrowing**
   Direct loans and primary and secondary bond market participation

6. Banks **help pension-funds and other investors manage their portfolio**
   Obvious examples include investment funds and financial market services

Measuring the cost of a crisis – a schematic



Point A: pre-crisis peak. Point B: post-crisis trough. Point C: GDP growth equals trend GDP growth for the first time after the crisis. Point D: the level of GDP returns to the pre-crisis level.

Source: Basel Committee on Banking Supervision, “An assessment of the long-term economic impact of stronger capital and liquidity requirements”, August 2010.

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How costly are crisis ?

Median output losses associated with a banking crisis[1]
(as a percentage of pre-crisis GDP)

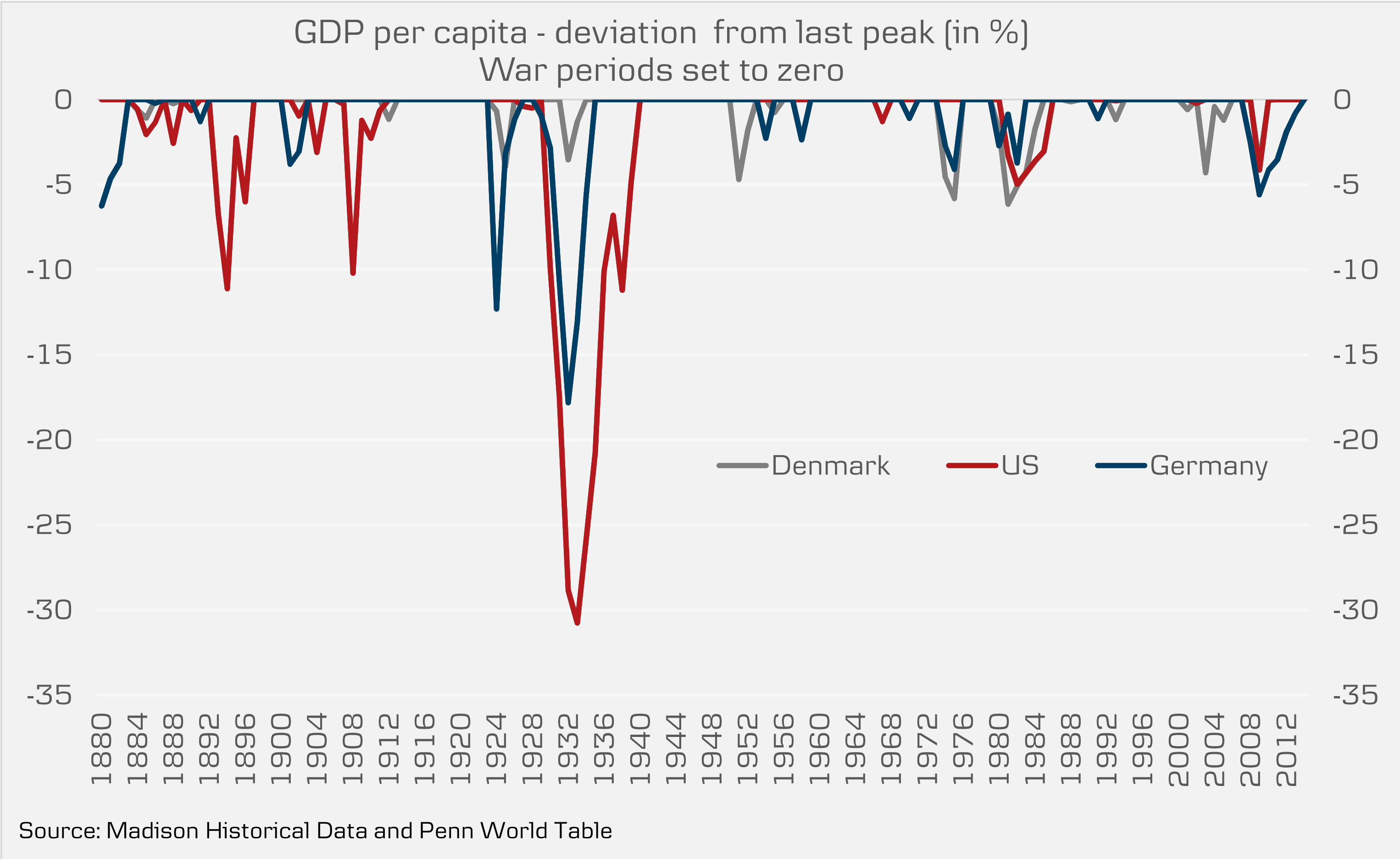
	Difference between GDP at beginning and end of period	Cumulative discounted loss
Period from peak to trough (A to B)	9	
Period until growth rate recovers (A to C)	10	
Period from peak to end of crisis[2]		19
Infinite horizon (in the presence of permanent steady-state effects) (δ, in example 2)	6[3]	158
Memo item: Median cumulative effect across all studies		*63*

[1] Numbers are medians of the results reported by a number of academic studies. See Annex 1 and Table A1.1for details. As a percentage of pre-crisis GDP. [2] The category includes studies where the endpoint for crises was determined by the time when GDP recovered to its pre-crisis peak, by expert judgment, or by assuming that crises last a fixed number of years. [3] Studies assessing the impact of banking crises on long-run output find on average a 10% effect. Studies using potential output (eg based on OECD estimates) find on average a 2% drop.

Source: Basel Committee on Banking Supervision, “An assessment of the long-term economic impact of stronger capital and liquidity requirements”, August 2010.

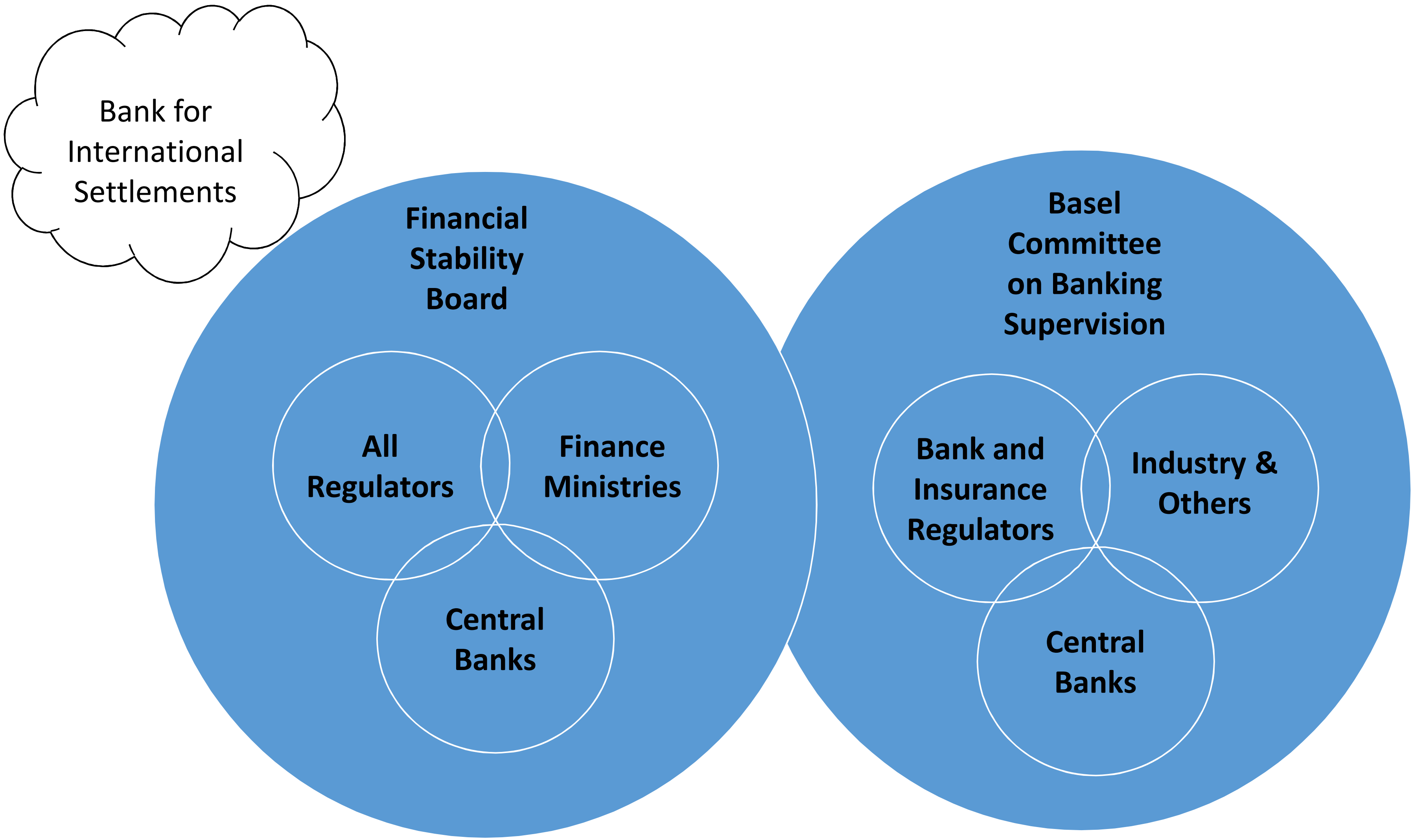
Financial crisis and Real Per Capita GDP, Denmark, Germany and United States 1880-2015

(Deviation as a percent of previous peak level)

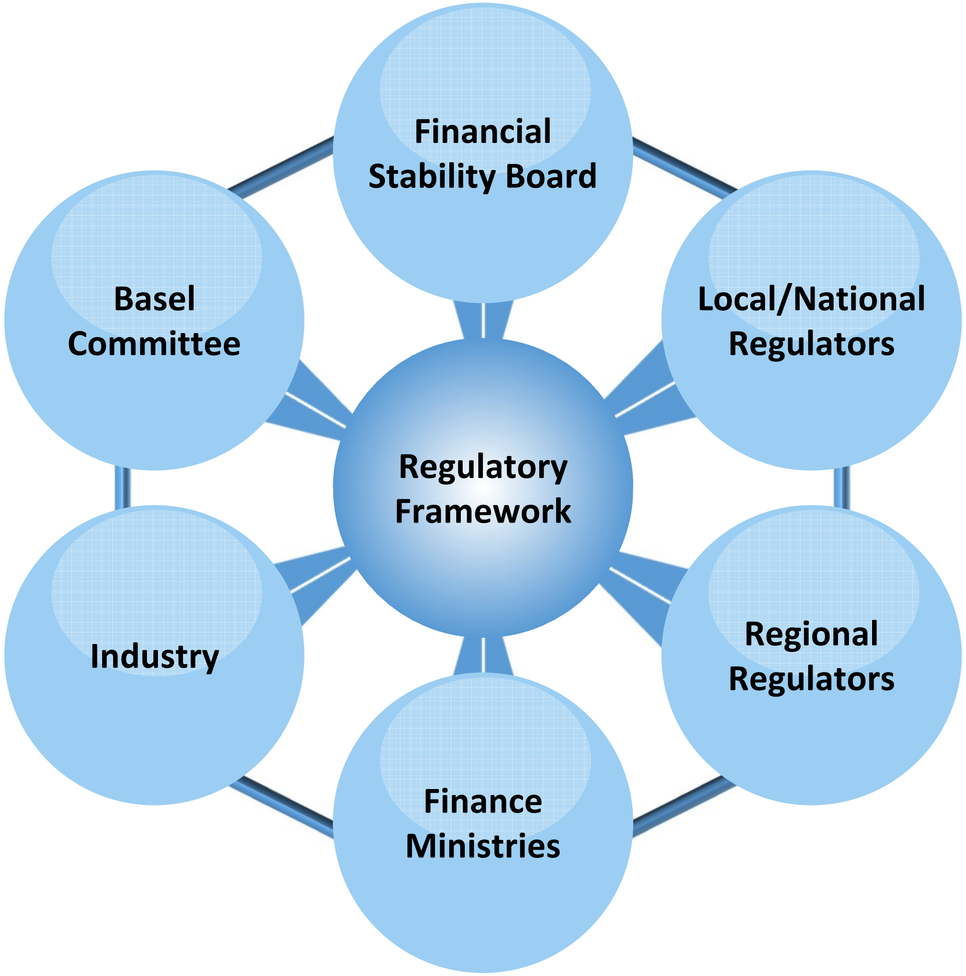


Where does regulation come from ?

Supra National Process Produces Generic "Soft Law"



Regional & National regulation is a tailored copy of the soft law



A New Regulatory Landscape – Response to the 2008 crisis

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New regulation after the crisis I

Capital

- Higher capital requirements for systemically important banks (SIFIs)
- Additional capital to cover for downside risk (market risk and credit risk)
- Additional capital to cover counterparty credit risk on OTC derivatives
- Limits on bank leverage (Leverage ratio based on non-risk-weighted assets)

Liquidity

- Larger liquidity buffers to ensure banks have enough cash when markets are stressed (Liquidity Coverage Ratio)
- Including liquidity buffers by currency

Funding

- New regulation to ensure banks rely less on short-term debt funding (Net Stable Funding Ratio)

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New regulation after the crisis II

Banks and markets

- Expansion of regulatory perimeter to capture bank links to shadow banks and infrastructure
- Increased post-trade price transparency
- Regulatory drive to increase use of central counterparties for derivatives
- Increased regulation of market and payments infrastructure
- Efforts to strengthen key reference indices (FX and Money market reference rates)
- Tougher stance on conduct (prison, bigger fines)
- Bank links to shadow banks (hedge funds, money market funds)
- Improve regulation of non-bank SIFIs (CCP, Mega Asset Managers, Data hubs etc.)

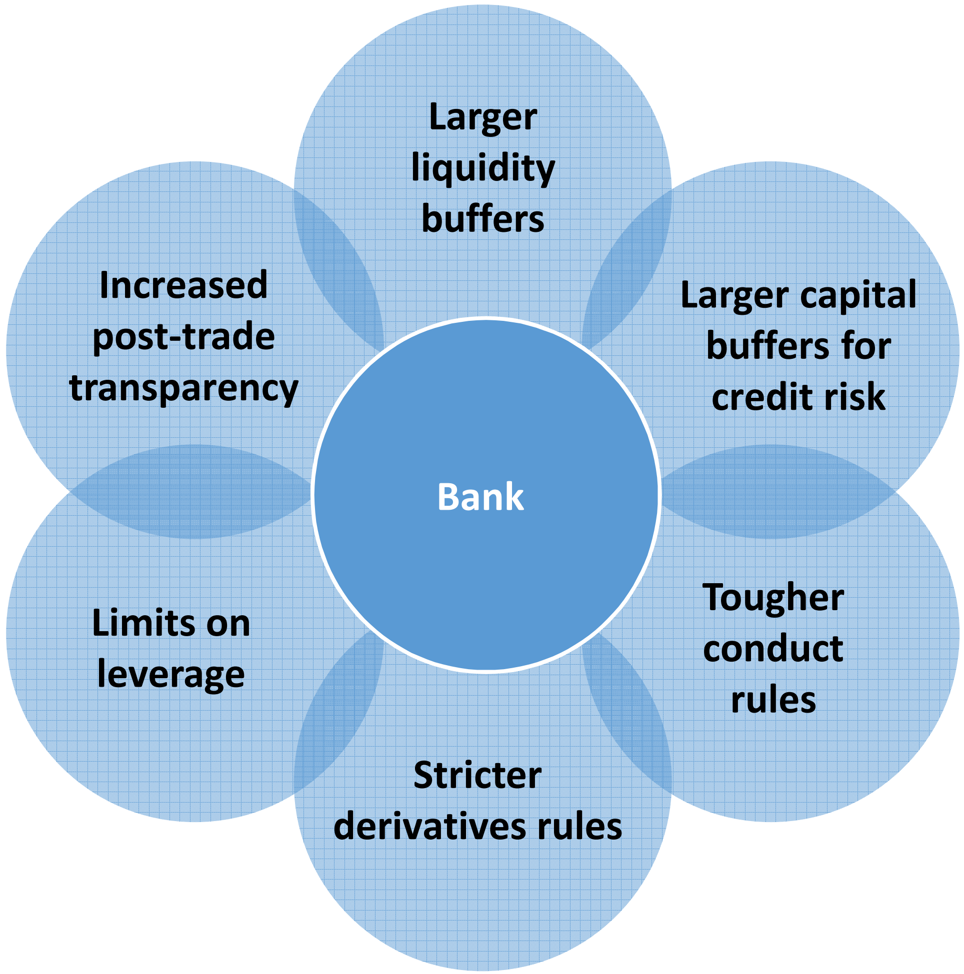
Information about system

- Improve fundamental global data infrastructure (Legal Identifiers)
- Increased granularity and frequency of reporting to regulators and markets

Fundamental Review of the Trading Book and "BASEL IV"

- Revision of Credit Risk Framework (Revamp of all approaches)
- Revision of market risk framework (Fundamental Review of Trading Book)

In short — many new challenges still ahead



Revision of Credit Risk Framework

Main elements of “Basel IV” revision

Why a revision?

- Key objective is reduce variation across banks
- Follows surveys which indicate significant variation in treatment of same exposures

What

Revision of standardised approach to credit risk

- Aligning parameters with foundation method
- Tougher treatment of off-balance sheet items

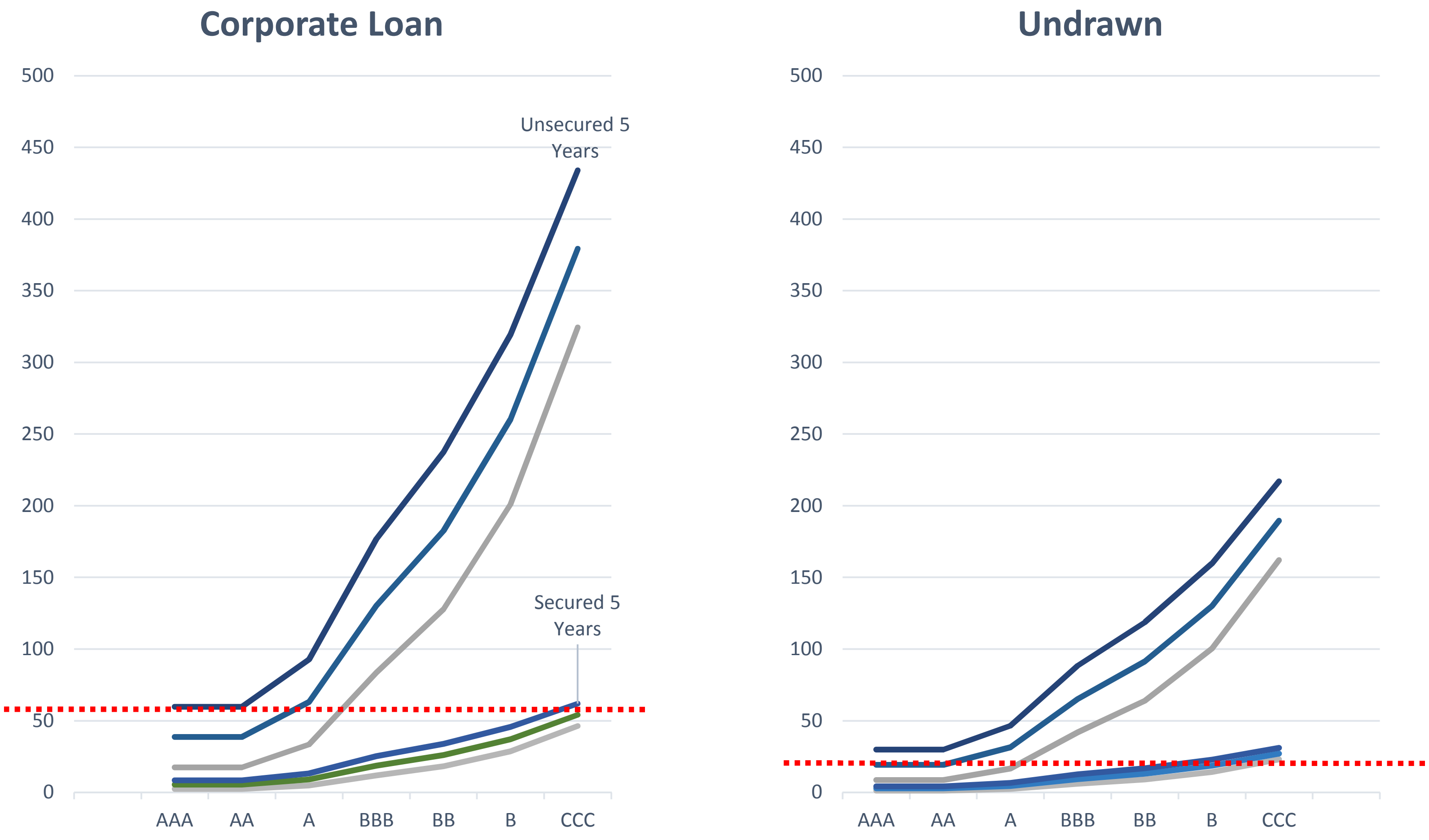
Banks/financials and Mega-corporates on standardised

Large corporates on foundation approach

Floors on required capital based on standardised approach

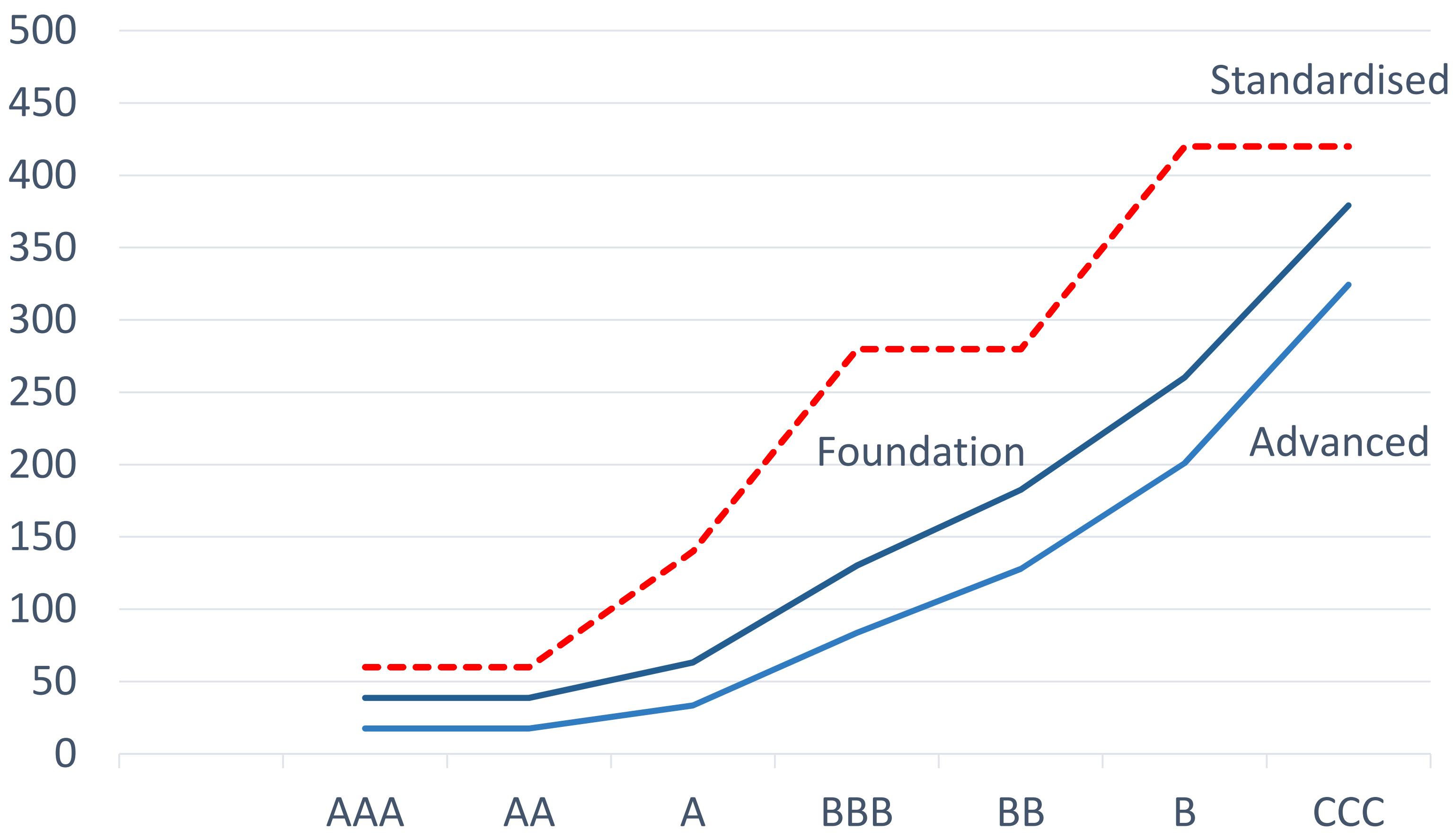
- 50-90% of standardised,still to be decided
- Floors based on individual exposures ?

Capital Cost *in basis points*



Basel IV - Indicative 1-year loan price

Basis points



Regulation has a visible impact on banking!

More capital per risk unit

- Banks will charge more to hold risk
- It will cost more for banks to facilitate the reallocation of market and credit risk
- Drive towards services and products that are focused on facilitating risk being shared with and directly transferred to non-bank investors
- Will likely change how loan-related credit risk is handled in the market-place going forward

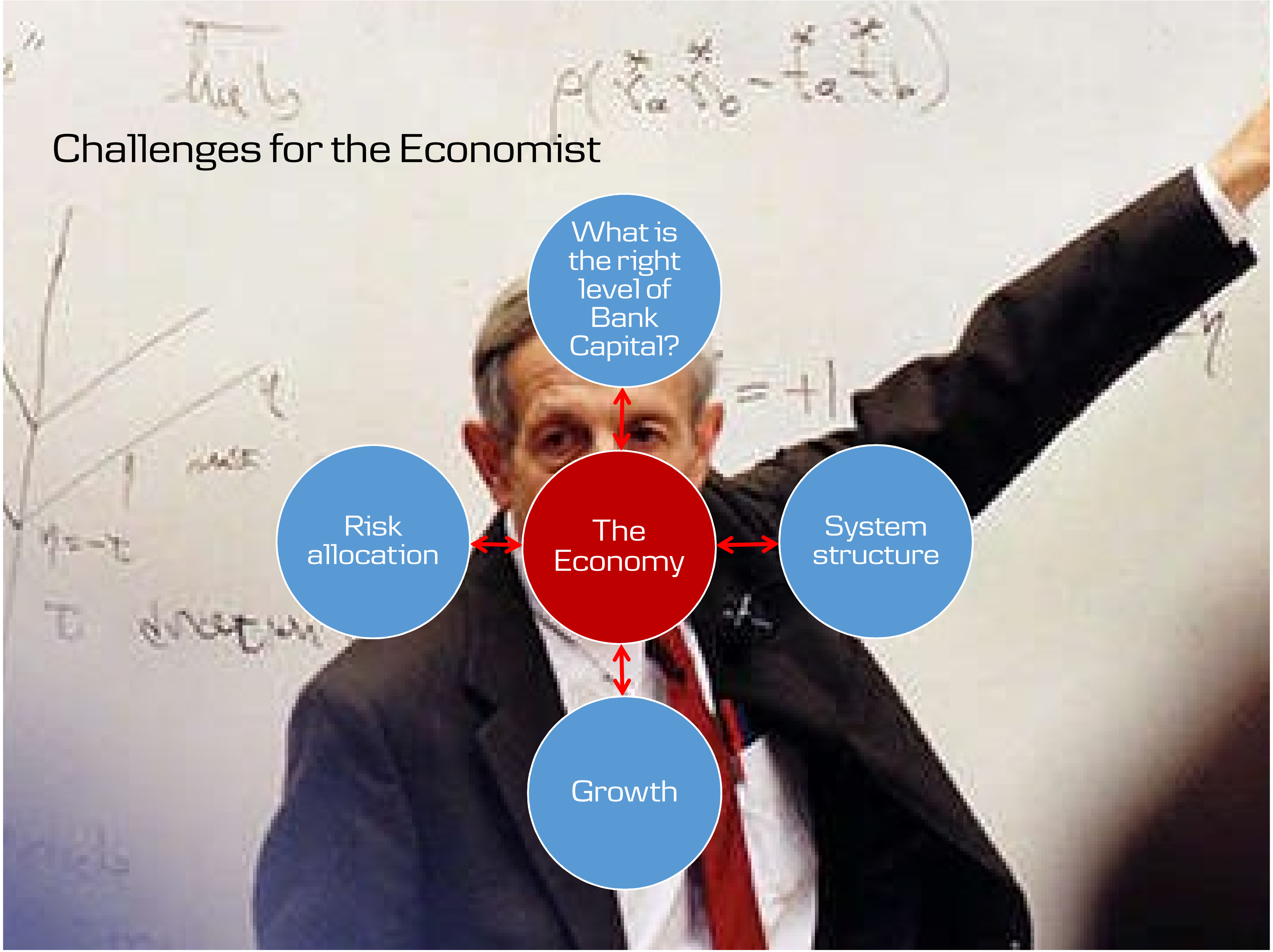
Higher liquidity buffers & fewer balance sheet maturity mismatches

- Banks will be forced to hold larger liquidity buffers with either cash or very liquid assets
- Bank funding costs will go up as they are forced to take on more long-term funding
- Will drive industry towards more granular and accurate pricing of liquidity and maturity transformation related risks
- This is already changing how banks operate in money, bond and FX markets

Conduct and taking on responsibilities to society

- Focus on sustainable business conduct and transparent business models
- Banks expected to help out on tax fraud and the battle against terrorism
- Banks expected to provide basic banking services for free/reduced payment and servicing the needs of all segments, regardless of being digital

Challenges for the Economist



Thank you