Evolution of the Basel Capital Adequacy Requirements

Address by Mr Rameswurlall Basant Roi GCSK, Governor, Bank of Mauritius, at the Seminar on "Enhancements to the Basel Process: Recent developments relating to Basel II & Basel III*" hosted by AFRITAC South, IMF*

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Ladies and Gentlemen

Thank you Mr Ravi Mohan, Resident Advisor to the IMF's AFRITAC South, for inviting me again to share my views on this very interesting topic: Capital Adequacy Framework. It's a great feeling to be in the midst of so many regulators from our continent. I said it's a "great feeling" because of "fellow feeling". Our contributions as regulators and supervisors of financial institutions to financial stability are seldom recognized. But we always hit the news headlines when all the sins of an ailing or a failed financial institution are conveniently heaped on us.

As regulators, we however need to have the unswerving faith in our abilities to regulate and supervise financial institutions that have become increasingly complex in a world where trillions of dollars flow across the world in a single day by the simple click of a mouse. True, at times, the weight of the regulatory and supervisory burden turns out to be exceedingly demanding, so demanding that it takes a serious toll on us. I am nevertheless truly happy – and very happy indeed – to be here, this morning, to address the participants of the AFRITAC South Seminar today on a topic that constitutes the very foundation of a safe and sound financial sector.

To set the backdrop for the sharing of your regulatory and supervisory experience during this Seminar, I believe it's fitting to go back into history in order to give it a sense of perspective. But before I do so, let me narrate a short childhood story about myself. In my native village which is in the southern part of this country, there was only one, what used to be commonly known as, barber's shop. The barber was a plain and financially lean countryside fellow. My parents used to send me to that barber's shop for a haircut about once every month in the early 1950s. Once seated in the chair for a haircut, no person could miss a framed picture of what looked like smartly dressed businessmen in an office with one of them in a standing position talking to the rest. A line at the top of the picture read as follows: "For Credit, Come Tomorrow." I was six years old or thereabout when I had first read it. And I had not then understood what it meant and why was this colourless picture glued against the wall side by side with a mirror in the full view of all the barber's clients. As I grew up, I had slowly started to get the gist of this line. Years later, I had asked a school friend about the barber who was not around anymore. I was told that the barber had gone out of business because he had given up the idea of, "For Credit, Come Tomorrow." I had then asked myself the question, “What if the principal business of an enterprise is not to give haircuts to people but to extend credit out of other people’s money?” Once I joined the Bank of Mauritius as an economist in the mid-1970s, I got a very wide angle view and a full-scale appreciation of the importance of capital for any enterprise, more specifically for financial institutions.

Regulators have long realised that capital is the backbone of a bank; it absorbs losses and it can prevent bank failures. What the capital base of a bank should be is a grand question. The determination of the right amount of capital has always been a very demanding exercise. Why is it so? It is primarily because of credit and the risks associated with it. By definition credit is the disposition of one person to trust another. It is singularly varying.

In the 1950s, the US Federal Reserve used the Analysis of Bank Capital to bring up a formal evaluation basis for banks’ capital adequacy. This approach was dropped in 1970 as it proved difficult to precisely determine the adequate quantum of bank capital in the face of the growing complexity of the system. The long period of financial repression, that is, direct control on bank lending to the private sector and force-feeding banks with government debt instruments had made the core business of commercial banks safe between the mid-1930s and the early 1970s. Central banks’ function of maintaining financial stability by way of regulation and supervision had atrophied. Questions were vigorously set as to how monetary policy could be better applied to forestall booms and busts. The collapse of the Franklin National Bank of New York and the collapse of the infamous Bankhaus Herstatt in 1974 had turned out to be a clarion call for putting emphasis on regulation and supervision of banks. The then financial crisis found both central banks and banks ill-equipped and lacking in respect of skills in risk management. They were both unprepared for disruptive shocks to financial stability.

For many years, a select group of central bankers used to meet regularly at the Bank for International Settlements in Basel. Supervisory officials, too, forming part of the central banking community had joined in to discuss matters of common interest. The Basel Committee on Banking Regulation and Regulatory Practices eventually took shape. If I understand correctly, it later came to be known as the Basel Committee on Banking Supervision (BCBS for short). The concerns for financial stability in the wake of the collapse of the two banks in 1974 I referred to earlier and the breakdown of the Bretton Woods system that subsequently ushered in a phase of financial sector liberalisation, including exchange control liberalization worldwide, gave rise to quite a wide spectrum of risks. If unchecked, they could jeopardise financial stability.

The first Basel standard, Basel I, also known as the Basel Accords, was a product of the Cooke Committee, after Peter Cooke from the Bank of England who chaired the Basel Committee for more than a decade. The Cooke Committee Report was agreed in 1988, a response to the collapse of the Franklin National Bank and of the Bankhaus Herstatt in 1974 and to other considerations. Basel I had set a minimum capital requirement for internationally active banks. The minimum ratio of regulatory capital to total risk-weighted assets was set at 8 per cent of which the ‘core capital’, a restrictive definition of eligible capital labelled as Tier I capital, stood at 4 per cent. It was designed to be implemented by the members of the BCBS by 1992, only four years after it was agreed. Basel I was amended in 1996 to take into account market risks in banks’ trading books, whereby an additional capital charge was introduced to cover market risk. Although Basel I was meant for implementation by members of the BCBS, many non-member countries with internationally active banks also started implementing the Basel standards.

Basel I had weaknesses. It did not differentiate enough the risks associated with individual loans, thus providing banks with opportunities for regulatory arbitrage. Basel I, overlooking operational risk, focused on credit and market risk only. These deficiencies demanded an improvement in the Basel standards. After years of intense debates and negotiations, Basel II was finally agreed in 2004. While leaving some basic parameters of Basel I unchanged, Basel II aimed at ensuring that the regulatory capital reflected actual risks banks were taking. In other words, Basel II dramatically altered the system for risk-weighting of assets. It, of course, goes to say that Basel II moved away from compliance-based supervision to a more complex risk-based supervision. Basel II thus assigned a pivotal role to the players, that is, banks and external credit rating agencies, in the workings of risk assessment. Banks were allowed, under the foundation Internal Ratings-Based approach, to use their own models for risk assessment by using metrics set by the supervisors.

I am sure most of you here must be aware that Basel II requirements were more elastic and institution-specific. They brought on the scene a risk management regime whereby banks could opt for either the standardised approach with its fine-grained risk categories linked to external credit ratings or the internal ratings approach where sophisticated mathematical models could be used. The years following the implementation of the Basel II Accord saw a surge in the reliance on various models by large international banks.

The 2008 financial crisis revealed weaknesses in Basel II. The risk-sensitivity of Basel II capital requirements were questioned as they were found to have exacerbated pro-cyclicality with deepened likelihood of crisis. The need to effectively address risks associated with securitization, counterparty credit exposure arising out of derivatives and securities financing was palpably felt. Basel III was thus agreed between 2010 and 2014; it seeks to increase the quantum and quality of banks’ capital beside introducing liquidity standards and macro-prudential measures for preventing the build-up of systemic risk.

With a view to giving a broad perspective of what is required of regulators in today’s world, let me give you a broad brush stroke of what Basel II and III are made of. Basel II, whose focus was mainly on refining the risk sensitivity of assets, encompasses the following:

1. Standardised Approach to credit risk;
2. Foundation Internal Ratings-Based approach to credit risk;
3. Advanced Internal Ratings-Based approach to credit risk;
4. Basic Indicator approach to operational risk;
5. Standardized Approach to operational risk;
6. Advanced Measurement approach to operational risk;
7. Standardized Measurement method for market risk;
8. Internal models approach to market risk;
9. Pillar 2 which is the Supervisory Review Process, and
10. Pillar III which is market discipline.

Basel III has enhanced the capital framework and introduced stringent liquidity standards along with a macroprudential flavour. The innovative elements of Basel III are:

1. Upgraded quality of capital;
2. Capital conservation buffer;
3. Countercyclical capital buffer;
4. Leverage ratio;
5. Liquidity Coverage Ratio;
6. Net Stable Funding Ratio;
7. Risk coverage – counterparty credit risk;
8. Capital surcharge on Global Systemically Important Banks;
9. Capital surcharge on Domestic Systemically Important Banks; and,
10. Total Loss Absorbency Capital (TLAC).

The foregoing gives a full view of what are expected of regulators in the standard-setting countries as well as in the standard-taking countries. It’s a formidable task for all of us. The majority of the world’s regulators are ‘standard-takers’ as far as international banking standards are concerned. They have no say in the standard-setting exercise and have no formal obligation to adhere to the standards. Yet many countries falling outside the BCBS are implementing them. Regulators in developing countries face enormous implementation challenges not only because of the complexity of the standards and the recalibration needed to reflect local contexts before they can be fully implemented but also because of gaps in financial market infrastructure and the lack of sophistication of the financial markets. Where these are missing, one could only expect low levels of implementation.

We have a bank-centric financial system in Mauritius. Of the 21 banks operating in our jurisdiction, 12 are foreign international banks. Two of our locally-owned banks have gone international. We therefore find it obligatory to adhere to the principles established by the standard setters of the BCBS. Basel I Accord was adopted in our jurisdiction way back in 1993. The Capital Adequacy Ratio initially set at 8 per cent was raised to 10 per cent in 1998. Basel II became operational in Mauritius as from March 2008 on a one-year parallel run with Basel I and was fully implemented as from March 2009. Of the three options for the measurement of credit risk, Mauritius elected to go by the Standardised Approach. Foreign banks were, however, given the latitude to compute their ratios using the more advanced approach for reporting to their head office. Pillar I, Pillar II and Pillar III were adopted in a phased approach. This allowed banks the necessary timeframe to align their risk management framework with the requirements of Basel II. To keep pace with international norms, Mauritius adopted Basel III in relation to its capital framework as from 2014. The capital framework included the conservation buffer of 2.5 per cent which is graduated for full implementation by 2020 when banks will need to maintain a ratio of 12.5 per cent. This does not represent a challenge for our banking industry as they are already maintaining a ratio averaging 17.8 per cent. With regards to the liquidity requirements under Basel III, the Bank of Mauritius has revised its Guideline on Liquidity requirements to incorporate Liquidity Coverage Ratio in line with the Basel III standards. By October this year, the Guideline is expected to become effective.

The two large and locally-owned banks which account for over 60 per cent of the domestic market and a few of the foreign banks are considered systemically important. The Bank of Mauritius has come up with a Guideline for Dealing with Domestic Systemically Important Banks. They are required to maintain a capital surcharge ranging from 1.0 to 2.5 per cent as from 2016, in addition to the capital adequacy ratio and the capital conservation buffer.

Even with the implementation of Basel III, the question remains: are good quality and quantity of capital sufficient to avert systemic shocks? Regulators and supervisors are pretty well aware that they are not. Basel III sets down the minimum standards. However, rules alone, no matter how well written and how consistently implemented, will not be enough to maintain the financial health and stability of the banking system. Poor risk management, interlinkages and common exposures can still give shocks to the financial system. For example, a bank's capital ratios can be rendered meaningless or highly misleading if they are based on inaccurate assessment of asset quality, off-balance sheet exposures and contingent liabilities. A bank may be reporting high capital ratios when in fact it may be insolvent due to poor asset quality and inadequate provision for losses. Furthermore, stringent capital requirements may be of little use if the corporate governance system of banks are deficient. Capital merely acts as a cushion against losses and can never be a substitute for poorly managed organisations. On-going vigilance in respect of corporate governance of banks as another over-arching priority in the supervision of banks is critically important.

Micro-level supervision, thus, effectively supplements the largely macro-prudential nature of the Basel III capital adequacy framework. Behavioural changes in banks, including change in culture, should top-up risk management practices for the effectiveness of any capital adequacy framework.

Let me take leave of you with a final thought: do never forget the story about the barber that dates back to the years before the 1970s. His business had collapsed not because of the variety of risks stemming from the rapid pace of technological progress (Schumpeter's creative destruction) but because of the risk associated with misplaced trust. The world has since changed cinematically and dramatically. In the decades before the 1960s, the life of tools, equipment and machines for production of goods and services lasted for 25 to 30 years. The cycle of obsolescence was so long that the risks of enterprises going bust because of technological progress were lower than they are today. Lending institutions faced lesser risks in those days. With digital technology, the cycle of obsolescence has accelerated. Just imagine the average lifespan of a phone app is a mere 30 days. We do not have enough time to master anything in today's world before it is displaced. The risks of enterprises and along with them lending institutions going bust are indeed unprecedentedly heightened. It's very difficult for any lender to appropriately assess risks arising out of digital advancement - and more so for any regulator. Lending institutions indisputably need much stronger capital buffers than in the past in order to meet the challenges of the unknowns.

With this final thought, may I wish you all the very best in your pursuit to know more about how best to implement the Basel standards of regulation of banks. The regulatory and supervisory community in Africa faces enormous challenges. I fervently hope that by the end of this Seminar you will have learned from each other quite some ways and means of improving your approach to regulation and supervision of financial institutions.

Thank you.

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