PROBLEMS AND CHALLENGES

The application of the "Basel 3" capital solvency ratio for banks

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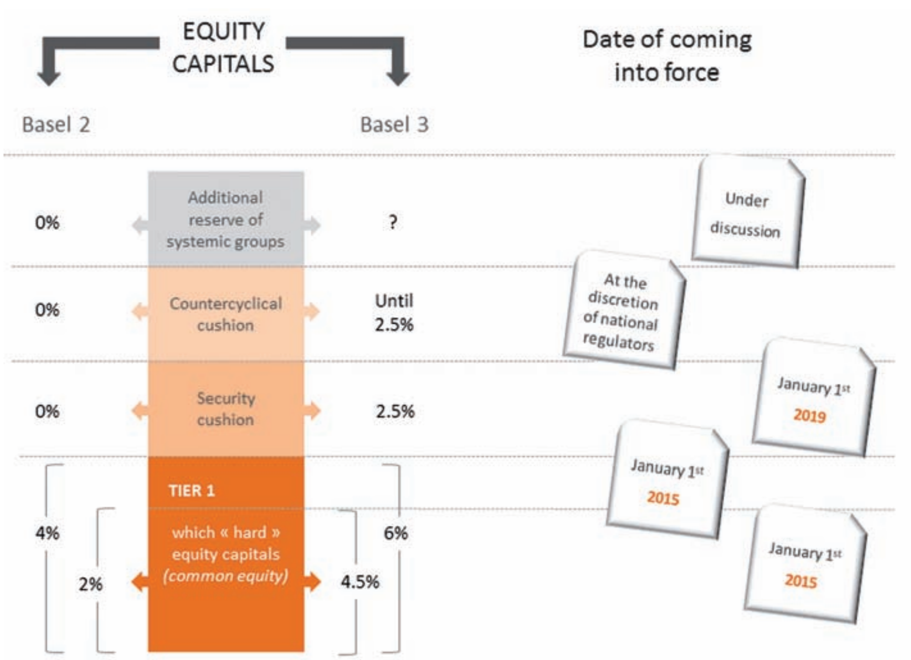
At the end of 2010, the "Basel 3" agreement released new prudential standards that are gradually forcing European banks to raise up their capital levels between 2013 and 2019. Now, these new requirements have changed the strategy of banks in managing their liquidity and cost of capital.

In 2007, the subprime financial crisis highlighted serious shortcomings in the management of bank portfolios around the world. The first lesson of this crisis is the excessive growth of bank balance sheets and off balance sheets materialized mainly by the proliferation and complexity of derivatives. Simultaneously, the other that emerges is the obvious degradation of the level and quality of capital to cover market risks.
As a consequence, many financial institutions that did not have enough financial resources to support the liquidity crisis either went bankrupt or were bailed out by the states at the end of 2008 and during 2009.
On 16 December 2010, the initiative to reform banking regulation was taken by the enactment of the "Basel 3" agreement to avoid a new future systemic risk related to the interdependence of banks and a new crisis of confidence and liquidity widespread in the international regulatory organizations, under the FSB (Financial Stability Board) and the G20 leadership. These should be gradually rolled out between 2013 and 2019, and apply mainly to European banks (American banks have adopted their own regulatory framework without applying the standards of Basel 2). The first key step to these agreements is to strengthen the quality and quantity of available capital in the banking system. In that sense, "Basel 3" provides an increase in the solvency ratio of Core Tier[1] that will rise from 2% (Basel2) to 4.5%, with a safety cushion of 2.5% (by 2019) in which banks can draw on case of difficulties. This means that the "hard" capital comprised exclusively by shares and preserved benefits into funds, will now represent a 7% of the market activities of banks or credit. In order to force banks to comply with these new requirements, the Basel 3 plan, to limit the distribution of dividends and bonuses as the capital ratio, does not account for 7% of their commitments.

More expensive and unstable

In this context, financial institutions have two options to settle down with this reform. Either they resort to the market or they stock up on the needed capital due to the potential benefits they will be able to generate. In order to effectively control their capital requirements, banks will have to learn to referee the most of their equity allocation according to market opportunities. They should also put under close supervision changes in their risk-weighted assets so that decisions taken in this area set up a new spur of action as potent as the one that carried out in terms of income and costs. Specifically, this approach leads to the implementation of tools for valuation of assets by type of activity and the development of specific deferred. Strategically, in terms of image, a poor assessment of risk-weighted assets is highly detrimental to the financial institution, because it reflects a failure of the

Capitals that banks should have
% of assets (calculated on basis of risk)



bank to provide the market with an objective anticipation and justified by results of the future exercises. Consequently and inevitably, investors who abhor uncertainty will surely punish the securities market.

The second part of Basel 3 agreement provides the establishment of two new liquidity ratios (Liquidity Coverage Ratio "LCR"[2] and Net Stable Funding Ratios "NSFR"[3]). Since the crisis of 2008, the refinancing terms of financial institutions in the markets have become more expensive and unstable. Thus the liquidity risk has become a very important parameter to manage market or credit risks. The aim of these new ratios is imposing on banks a more conservative management of their liquidity.

Even though national and European regulators recommend an observation phase, banks are preparing, from now on, the introduction of these new indicators, on the one hand, for being fully operational within the time limits imposed by regulators and, on the other hand, for demonstrating to their clients, counterparties, and shareholders, the ability of the establishment to adapt and effectively manage regulatory constraints and external events.

Since the beginning of 2011, some banks have already anticipated liquidity constraints proposed by European regulators, tightening up significantly their constraint liquidity in dollars and euros on volumes in the medium term. Meanwhile, a number of banks have implemented volume indicators of liquidity by job. The purpose of these ratios is to calculate the net balance of funding, that is to say, the difference between assets on the balance sheet and liabilities established according to rules set by the bank. In addition, steering and surveillance committees have been implemented by some stakeholders to define and control their managing capital and liquidity polices for each of their activities. Thus commercial teams are beginning to be aware of these issues and guide their actions in order to be fully consistent with this new strategy.

An opportunity for banks

Some institutions are even considering, in their investment banking activities, to be separated from important historical and too greedy customers in terms of capital allocation and without having a decent "Allocated capital/ Net Profitability" ratio. The deployment of this device offers those banks that have adopted it the opportunity to integrate a recently introduced constraint in their "business model", which is undoubtedly destined to be perpetuated over time: liquidity risk. In a context where issues of liquidity and capital lead to a reorganization and improvements in the areas of activity by country and jobs, control and cost control within each activity is the basic trend detected in the present among the major European banks.

Levers operated by banks to manage their costs can be materialized in different ways:

- A new strategic estimation in jobs like financial engineering, marketing and innovation.
- An improvement of process and industrialization of the computer tools at the best price/ quality ratio.
- A complete reorganization of back office and middle offices structures. For example, the growing increase of liquidity costs encourages more and more banks and businesses to diversify their risks and limit the financial strength invested in each deal. In this context, the number of syndicated loans and their complexity grows with the number of participants and with the increasingly significant phases. Departments in charge of processing these services must be reorganized accordingly and adapted to this changing market.
- An evolution of the recruitment policy that aims to optimize the redeployment. The emphasis is on the management and allocation of expenditure related to external resources.

The implementation of the cost management, liquidity control and capital adequacy is an opportunity for banks to apply as soon as possible. This will allow them to enjoy a decisive competitive advantage in a complex and challenging economic environment.

1 - See the graph
2 - LCR: Ratio to one month designed to enable banks withstanding severe liquidity crises over a period of a month.
3 - NSFR: Ratio of one year designed to enable banks withstanding during a year to a specific situation of crisis to the organization.
Its principle is: the amount of the required stable funding must be less than the available stable funding.