

Global Supervisors Closer to Strengthening Capital and Liquidity Requirements September 9, 2009

This week several important near-term initiatives of the Basel Committee on Banking Supervision were announced by the Group of Central Bank Governors and Heads of Supervision.¹ While none of the agreed-upon initiatives are new to the scene, concrete proposals are now expected by the end of the year. The announced measures are discussed below.

Composition of Capital

Rules governing eligible capital instruments will be revised to ensure that common equity and retained earnings are the predominant forms of Tier 1 capital. This may or may not be a significant change for banks, given that many supervisors – including in the US – are already expecting the majority of Tier 1 capital to be in common equity. The impact of this change will of course also depend on how “predominant” is ultimately defined. The US Treasury has called for common equity to be a “large majority” of Tier 1 capital.²

Leverage Ratio

A leverage ratio will be introduced as a supplementary measure to the Basel II risk-based framework. Ultimately the leverage ratio is to be “migrated to a Pillar 1 treatment” – presumably meaning that it will become an additional minimum capital ratio. The import of this initiative will depend on the level and definition of the leverage ratio. It will have little impact on US banks if it mirrors the existing leverage ratio in the US. However, there is some official support for considering incorporating off-balance sheet exposures into the ratio, so that it can more effectively operate as a backstop ratio against those riskier activities.³ Such an approach could edge closer to the Basel I definition and result in an additional capital ratio that US and other banks have to meet.

Countercyclical Capital Buffers

The Basel Committee will develop ways to promote a build-up of a capital cushion during cyclical expansions, which can be reduced during downturns as losses occur.

¹ The Group of Central Bank Governors and Heads of Supervision is the oversight body of the Basel Committee on Banking Supervision. Both groups have the same 27 member countries. The Group’s September 7, 2009 statement, and information about the Basel Committee’s work and membership, can be found at www.bis.org.

² US Treasury Department, *Principles for Reforming the US and International Regulatory Capital Framework for Banking Firms*, September 3, 2009, http://www.treas.gov/press/releases/docs/capital-statement_090309.pdf.

³ See, for example, US Treasury Department September 3 2009 release, as well as Financial Stability Board, *Report of the Financial Stability Forum on Addressing Procyclicality on the Financial System*, April 2009, http://www.financialstabilityboard.org/publications/r_0904a.pdf.

Among the tools considered will be constraints on capital distributions. The Committee plans to develop cyclical indicators that will determine the implementation of the requirements. As part of the effort to dampen the procyclicality inherent in the provision of credit, the Committee will also promote forward-looking provisions for credit losses.

Capital Requirements for Systemic Banks

The Committee will consider whether a capital surcharge is needed for systemically significant banks. Should they decide to implement such a measure, they would have to define systemically significant as well as develop a methodology for the surcharge. While there is a lot of sentiment for going down this road, the issues are controversial and raise the specter of extending capital regulation to non-banks, a subject that is in flux in the US and other countries. The most that is likely to come from the Basel Committee by the end of the year is a discussion paper on the subject.

Liquidity Framework

An explicit liquidity regulatory framework will be proposed. It will include a “stressed funding liquidity ratio”, which would require banks to hold liquid assets sufficient to weather acute funding shortfalls due to stressed market conditions. This has been referred to by some as a core funding ratio. The framework will also include a structural liquidity ratio, with the goal of minimizing the risk of a bank’s longer-term asset-liability strategy. In addition to these ratios, supervisors will be expected to step up their oversight of banks’ liquidity risk management.

Compensation

The Group of Central Bank Governors and Heads of State also agreed that supervisors should build on the Financial Stability Board’s sound compensation principles by ensuring that compensation is aligned with prudent risk-taking and long-term, sustainable performance.⁴ While new rules are not necessarily expected, banks should not discount the importance of the recently-issued principles, which lay out expectations that compensation practices be firmly rooted in risk management systems and actively overseen by the Board. In the US and other jurisdictions, additional supervisory guidance is anticipated.

Implementation

The Basel Committee will issue concrete capital and liquidity proposals by the end of the year. The statement noted that government capital injections will be grandfathered. Comments will be taken, the proposals will be calibrated during 2010, and the new requirements will be finalized by the end of 2010. Although governments will want to phase in requirements over time so as not to jeopardize economic recovery, banks may find the market will expect prompt implementation.

⁴ Financial Stability Board, *FSF Principles for Sound Compensation Practices*, April 2009, http://www.financialstabilityboard.org/publications/r_0904b.pdf.