BIS: Comprehensive response to the global banking crisis

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Bank for International Settlements press release: The Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, met on 6 September to review a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector. These measures will substantially reduce the probability and severity of economic and financial stress.

President Jean-Claude Trichet, who chairs the Group, noted that "the agreements reached today among 27 major countries of the world are essential as they set the new standards for banking regulation and supervision at the global level".

Mr Nout Wellink, Chairman of the Basel Committee and President of the Netherlands Bank, stated that "central banks and supervisors have responded to the crisis by strengthening microprudential regulation, in particular the Basel II framework. We are working toward the introduction of a macroprudential overlay which includes a countercyclical capital buffer, as well as practical steps to address the risks arising from systemic, interconnected banks".

The Central Bank Governors and Heads of Supervision reached agreement on the following key measures to strengthen the regulation of the banking sector:

- Raise the quality, consistency and transparency of the Tier 1 capital base. The predominant form of Tier 1 capital must be common shares and retained earnings. Appropriate principles will be developed for non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Moreover, deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies. Finally, all components of the capital base will be fully disclosed.
- Introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting.
- Introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.
- Introduce a framework for countercyclical capital buffers above the minimum requirement. The framework will include capital conservation measures such as constraints on capital distributions. The Basel Committee will review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build up and release of capital buffers. In addition, the Committee will promote more forward-looking provisions based on expected losses.
- Issue recommendations to reduce the systemic risk associated with the resolution of cross-border banks.

The Committee will also assess the need for a capital surcharge to mitigate the risk of systemic banks.

The Basel Committee will issue concrete proposals on these measures by the end of this year. It will carry out an impact assessment at the beginning of next year, with calibration of the new requirements to be completed by end-2010. Appropriate implementation standards will be developed to ensure a phase-in of these new measures that does not impede the recovery of the real economy. Government injections will be grandfathered.

Mr Wellink emphasised that "these measures will result over time in higher capital and liquidity requirements and less leverage in the banking system, less procyclicality, greater banking sector resilience to stress and strong incentives to ensure that compensation practices are properly aligned with long-term performance and prudent risk-taking".

The Group of Governors and Heads of Supervision endorsed the following principles to guide supervisors in the transition to a higher level and quality of capital in the banking system:

- Building on the framework for countercyclical capital buffers, supervisors should require banks to strengthen their capital base through a combination of capital conservation measures, including actions to limit excessive dividend payments, share buybacks and compensation.
- Compensation should be aligned with prudent risk-taking and long-term, sustainable performance, building on the Financial Stability Board (FSB) sound compensation

principles.
- Banks will be required to move expeditiously to raise the level and quality of capital to the new standards, but in a manner that promotes stability of national banking systems and the broader economy.

Supervisors will ensure that the capital plans for the banks in their jurisdiction are consistent with these principles.

Comments by Financial Times: Regulators have agreed tough new rules for banks that flesh out proposals agreed by the G20 group of nations over the weekend that would force many in Europe to raise tens of billions of euros in capital in coming months.

The rules will force banks to substantially improve the quality and extent of the capital buffers they hold to absorb shocks.

At least half of the capital cushion of banks must comprise common equity and retained earnings under measures agreed by the powerful Basel committee of central bank governors and bank regulators, according to people familiar with the discussions.

The committee also agreed to put ?hard? limits how much banks can borrow. It is likely to set a ceiling on borrowings of no more than 25 times assets. There will be no exceptions for less risky assets.

Moreover, it also agreed that bank supervisors should be able to limit the ability of banks to make payouts to shareholders through dividends or buy-backs when times are good, enabling them to build ?counter-cyclical? buffers against bad times.

The Basel committee is expected to put out concrete proposals by the end of the year and adjust them by the end of 2010 after carrying out an impact assessment.

European banks are expected to be hardest hit by the Basel committee moves as complex securities constitute a large part of their capital cushions than their US peers. The securities, a mixture of debt and equity, are known as hybrid capital.

Hybrid capital covers a variety of instruments, such as preference shares, that are not pure equity but have traditionally been deemed close enough to it to count towards a bank?s tier one capital ratio ? the key measure of financial strength.

Some European banks have traditionally held a lot of their capital in hybrid form in an effort to minimise the dilution to equity investors from having to raise fresh funds. Regulators in Europe have allowed banks to hold more hybrid capital than their US counterparts ? up to a third of total tier one capital in some jurisdictions. But that has proved problematic in the financial crisis, since hybrid capital does not have the same loss-bearing capacity as true shareholders? equity.

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