

## BASEL III COMPLIANCE FOR GCC BANKS

# ANTICIPATING ITS IMPACT WITH EDUCATION & TRAINING

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After much debate in 2010, the Basel Committee of Banking Supervision announced its endorsement of Basel III, a new package of reforms for banks that is designed to improve the banking sector's ability to absorb financial and economic shocks, improve risk management and governance and strengthen banks' transparency and disclosures. The package builds on the existing regulatory structures of the Basel I and Basel II accords.



The new Basel III regulations include requirements for higher and better-quality capital, a new leverage ratio, better risk coverage, two global liquidity standards and the accumulation of capital that can be used in periods of financial stress. However, many banks had argued in the commentary phase that the new capital requirements could slow or reverse the economic recovery, including those in the Middle East.

Though Basel III was endorsed by G-20 leaders at their Seoul Summit in November, its full implementation will not take place until 2019. In order to prepare for the new Basel III requirements, Gulf Cooperation Council (GCC) banks should consider earlier implementation to provide themselves with a reputational boost, as well as a competitive advantage. The key to success during this process is preparing a bank-wide Basel III education and training program.

## NO TIME LIKE THE PRESENT

Now is the time for Middle Eastern banks to obtain the knowledge they will need to comply with the new Basel III requirements. The sooner that banks have a real understanding of the new framework, the sooner they can create new processes and train employees to ensure bank-wide compliance. Depending on how far away individual banks are from meeting the standards, compliance with the new rules could cause major changes in the ways they do business, from internal modelling to priorities in acquisition and disposal of assets.

## HELPING THE REGION GROW

Many industry experts agree that the Basel III regulations will fit well with the Middle Eastern region's banking needs. According to remarks from Eric Mottu, International Monetary Fund resident representative in Lebanon, at the Union of Arab Banks Annual Conference in November 2010, the Basel III initiatives that relate most to the region are:

- Reducing cyclicity in financial markets.
- Establishing stronger liquidity standards.
- Addressing systemically important financial institutions.
- Improving bank resolution frameworks.

Though these elements of Basel III may be of the most interest to GCC banks, other issues include a reduced reliance on

banks' internal models, a greater focus on stress testing, the coverage of risks related to capital market activities and dealing with systemically important markets and infrastructures.

## COUNTER-CYCLICAL MEASURES

Banks in the GCC expect profits to grow by 10 percent to 11 percent in 2011, according to the Union of Arab Banks. However, while financial inflows are growing, they are also volatile due to the cycles of the gas and oil sector and world markets, among other factors. While many banks in the region saved adequate capital and were able to avoid the worst of the recession, counter-cyclical measures are particularly important for the banking sector in the Middle East to avoid boom-and-bust cycles and encourage inflows to be used for more productive uses, such as infrastructure.

The most significant development of Basel III is the establishment of new requirements for capital that are designed to encourage banks to build up capital during boom times to be used in lean times to avoid busts. The first change is that a higher quality of capital will be required and it should be more transparent. The new regulations tighten the definition of Tier 1 capital to largely mean common equity (common shares and retained income). The rules increase the requirements for Tier 1 capital from 4 percent to 6 percent.

Under Basel III, banks are required to hold 4.5 percent of common equity in relation to risk-weighted assets, with an additional 2.5 percent capital conservation buffer that can be drawn upon in challenging economic times, bringing the bringing the total common equity requirements to 7 percent from the former 2 percent. Total capital required is 8 percent relative to risk-weighted assets.

A fundamental change is that regulators now have the power to enforce capital conservation discipline, including the restriction of distributions such as dividends and bonuses when banks get close to the minimum requirements.

One new tool that has been used in the United States but was never before required for the Basel framework is a leverage ratio, which is a measure of a bank's Tier 1 capital as a percentage of its assets, plus derivatives and off-balance sheet exposures, designed to supplement risk-based measures of regulatory capital. The new framework will test out a 3 percent unweighted ratio over a transition period through 2017,

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with adjustments made in the first half of 2017 to be fully effective starting in 2018.

Another valuable tool is an additional countercyclical capital buffer that can be instituted by national regulators on a country-by-country basis of up to 2.5 percent of common equity or other fully loss-absorbing capital. The buffer would be designed to be instituted during times of faster credit growth. Ideally, it would act as a brake on lending during these periods as well as ensure that credit remains available during times when credit is more restricted.

### LIQUIDITY STANDARDS

Another aspect of Basel III that is important to GCC banks is establishing stronger liquidity standards. Stress testing, a process that requires banks to calculate their capital adequacy at statistically unlikely but possible extremes, is treated as a purely voluntary procedure for banks in the Middle East and is not performed by governmental or regulatory agencies.

Initially, the Basel Committee proposed that banks should have enough cash or cashable assets to meet liabilities for up to a year. That standard has not yet been decided upon and an observation period of four to six years has been instituted. However, GCC banks can still take steps to ensure that they can withstand the possibility of worsening economic conditions and prevent financial crisis from occurring by preserving their liquidity and capital adequacy.

### SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

Another element of Basel III of particular import to Middle East banks regards systemically important financial institutions (SIFIs). While the Basel Committee believes that sys-

temically important banks should be able to absorb even more losses than that required by the basic Basel III standards, this framework is in development but should be completed by mid-2011. A systemic capital surcharge for such banks would be a possible solution.

The work on SIFIs illustrates the fact that several of the Basel III changes will take years to implement, with many under close review to see how they will work. It's clear that the rules will continue to be refined and it is crucial for GCC banks to have a thorough knowledge of the current rules to lay a strong foundation for keeping up with the evolution of regulations.

### BANK RESOLUTION FRAMEWORKS

Another pressing issue in banking regulation is how to wind down failing banks whose business crosses global borders; for example, the 2008 bankruptcy of Lehman Brothers Holdings Inc. While the issue has been debated by the Financial Stability Board, which is comprised of finance ministers from G-20 countries as well as most Basel Committee members, no agreement has been reached and a decision has been postponed until 2011.

### FINAL WORD

With the new regulations also come opportunities for GCC banks to build on their strengths and work on their weaknesses, in step with similar efforts throughout the world of banking. With many new rules and regulations emerging, banks must ensure that their employees not only have a thorough understanding of how these new developments will affect their work, but they must also be flexible in order to adapt to an ever-changing compliance landscape. Education, training and a thorough understanding, not just of the rules, but of the principles behind them, will be a must for GCC banks as they move forward into the future of global compliance.



### ABOUT THE AUTHOR

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