IMPROVING SUPERVISORY MECHANISM IN THE BANKING SECTOR OF THE OIC MEMBER COUNTRIES

Global Financial Markets and Banking

COMCEC COORDINATION OFFICE

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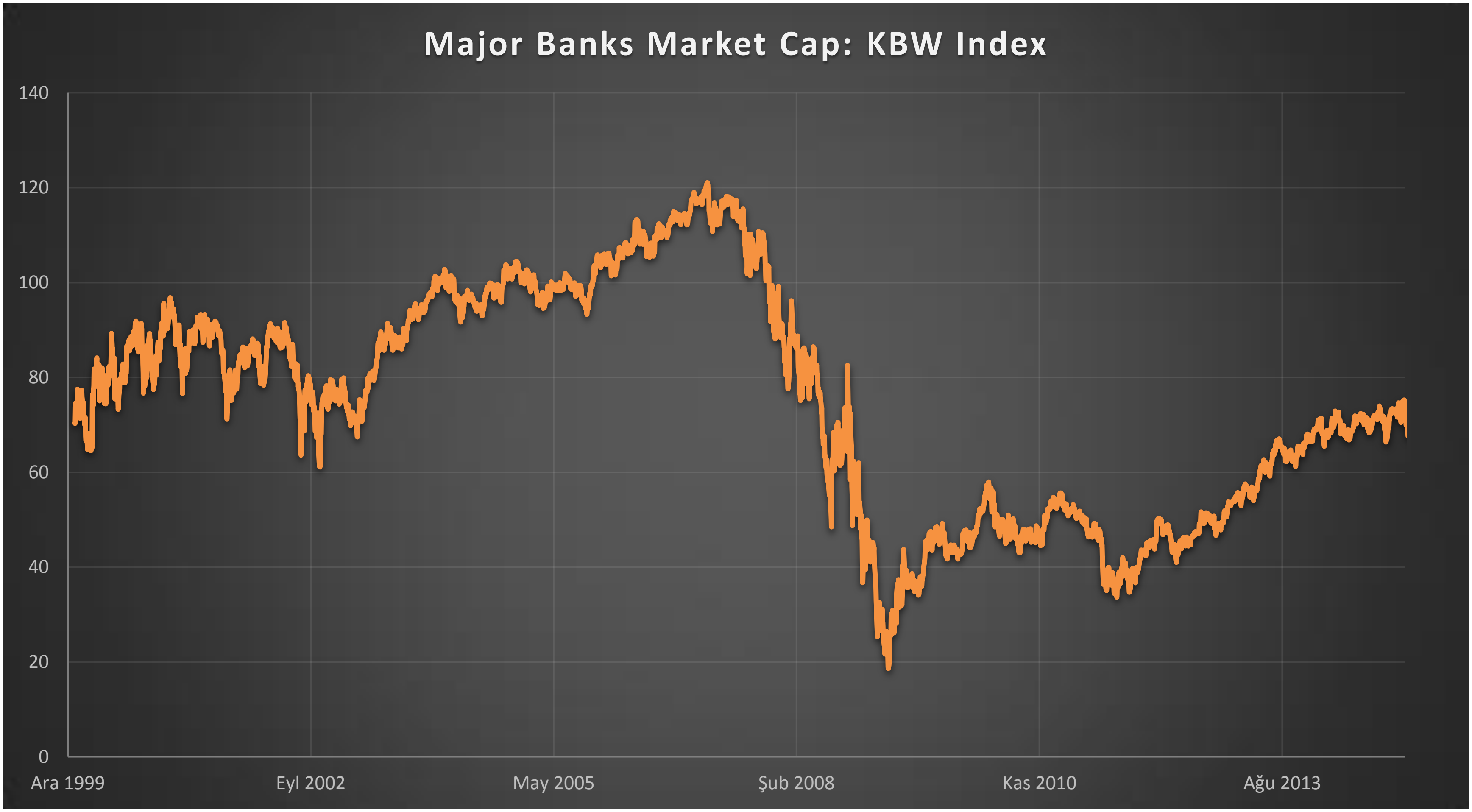
Standing Committee
for Economic and Commercial Cooperation
of the Organization of Islamic Cooperation
(COMCEC)

Outline

- Recent global trends and future of banking regulation after Basel III

Banking Sector after Credit crisis



Main Changes in Basel III

- Improving the quality of bank capital:
  - ✓ Under Stress periods good quality capital wipes out
- Dealing with pro-cyclicality: Capital Buffers
  - ✓ GDP and credit risk is positively correlated
- More capital penalty for complex derivatives and securitizations
  - ✓ Securitazion was helping to reduce capital

Main Changes in Basel III

- Simple risk measures: leverage ratio
- Liquidity: Liquidity Coverage Ratio (LCR) and Net Stable Funds Ratio (NSFR)

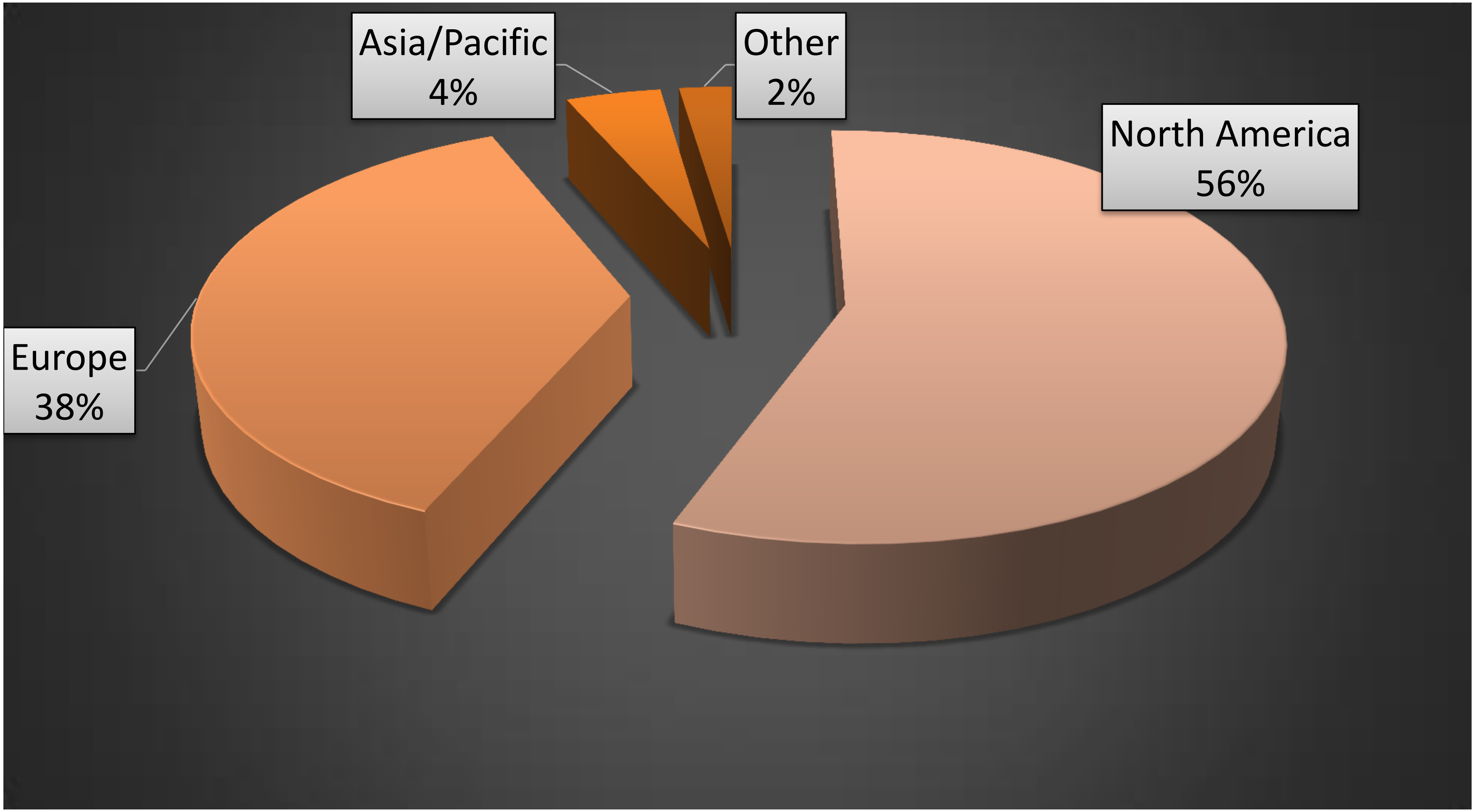
Main Changes: BASEL III

- Market Risk Charge: Stress VaR
  - Conventional risk measures do not cover market risk
- Counterparty risk charge
  - To avoid Lehman like episode.

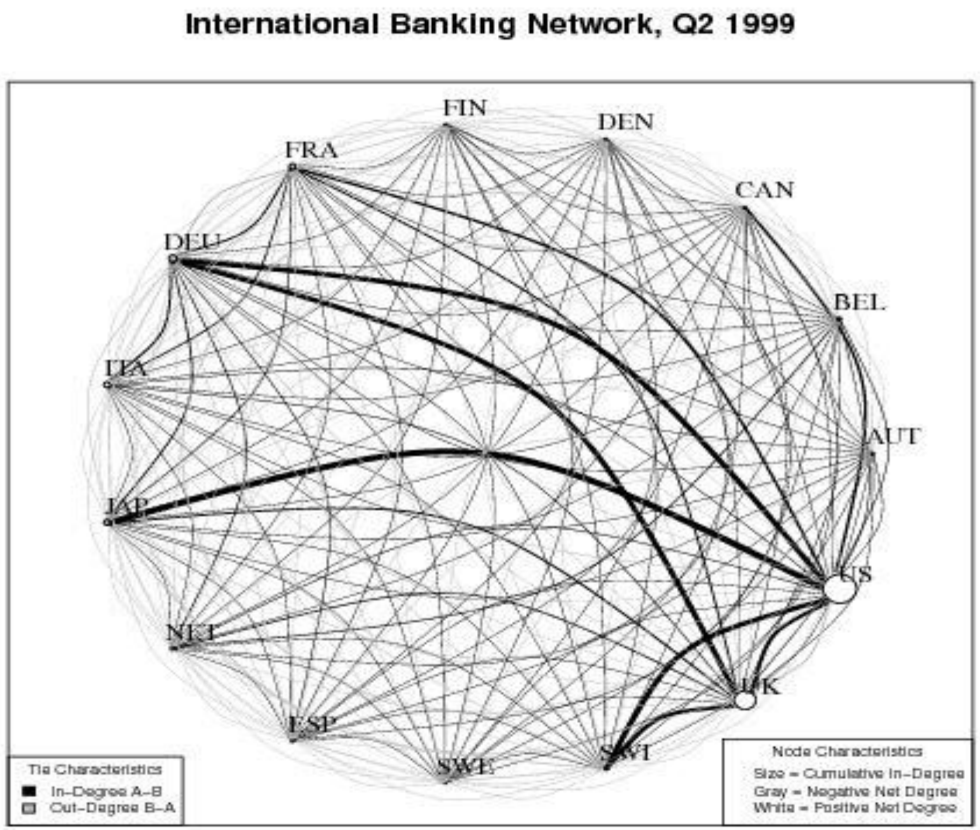
Changes with BASEL III

- Systemic risk:Globally Systemically Important Banks, or GSIB, DSIB
- Changing the supervisory mechanisms to adopt these global changes

Use of derivative products:2014



Banking network and systemic risk



Time-table for new BASEL III Requirements

	Phases	2013	2014	2015	2016	2017	2018	2019
Capital	Leverage Ratio	Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.50%	4.00%	4.50%				4.50%
	Capital Conservation Buffer				0.625%	1.250%	1.875%	2.500%
	Minimum common equity plus capital conservation buffer	3.50%	4.00%	4.50%	5.125%	5.75%	6.375%	7.00%
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%
	Minimum Tier 1 Capital	4.50%	5.50%	6.00%				6.00%
	Minimum Total Capital	8.00%						8.00%
	Minimum Total Capital plus conservation buffer	8.00%			8.625%	9.25%	9.875%	10.50%
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital	Phased out over 10 year horizon beginning 2013						
Liquidity	Liquidity coverage ratio - minimum requirement			60%	70%	80%	90%	100%
	Net stable funding ratio						Introduce Minimum Standard	

Quality of Capital

- Common equity (common shares and retained earnings) must be the dominant form Tier 1 capital.
- Tier 2 capital is simplified.
- Elimination of Tier 3 capital and imposition of a more stringent criteria for each instrument.
- Procyclicality and capital buffers

Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

- Liquidity Coverage Ratio (LCR) : to promote the short-term resilience of the liquidity risk
- Ample High Quality Liquid Assets (HQLA)
- A significant stress scenario lasting 30 calendar days.

LCR and NFSR

Table 1: Minimum LCR Ratios Applicable Each Years

Year	**2015**	**2016**	**2017**	**2018**	**2019**
Minimum LCR	60%	70%	80%	90%	100%

- Net Stable Funding Ratio (NSFR) measures the amount of long-term and stable sources of funds relative to the liquidity of assets. Minimum amount of funding to be stable over a time horizon of one year.

Systemic Risk Charges

- An additional requirement will be put on banks through their interconnectivity and asset size. Depending on the size and contagious risks, banks might need to put aside additional capital.

Bucketing Approach

Bucket	Score range*	Minimum additional loss absorbency (common equity as a percentage of risk-weighted assets)
5 (empty)	D -	3.50%
4	C - D	2.50%
3	B - C	2.00%
2	A - B	1.50%
1	Cut-off Point - A	1.00%
***Scores equal to one of the boundaries are assigned to the higher bucket**		

Leverage Ratio

- Simplify the risk-based requirements by switching to a simple, non-risk-based “backstop” measure.
- Restrict the build-up of excess leverage in the banking sector
- Ensures both the use of on- and off-balance sheet assets.
- Leverage ratio = Capital measure/Exposure measure,
  - capital measure for the leverage ratio should consist of Tier 1 capital.

Systemic Risk Charges

Table 1: Systemic Risk Charge under BASEL III

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Source: BIS (www.bis.org)

Summary of Reforms

- *Increased overall capital requirement*: Between 2013 and 2019, the common equity component of capital (core Tier 1) will increase from 2% to 4.5%
- A new 2.5% capital conservation buffer will be introduced, as well as a zero to 2.5% countercyclical capital buffer. The overall capital requirement (Tier 1 and Tier 2) will increase from 8% to 10.5% over the same period.
- More liquidity needed to be hold in the form of cash or High Quality Liquid Assets.
- Trading and use of derivative instruments will be restricted.
- More capital will be required against counterparty risk.

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Recent changes on derivative trading

- Establishment of Central 'Central Counterparty Clearing House’ **(CPP)**
- **Trading of derivatives:** Swaps and forwards and CDS’s
- OTC’s working mechanism will converge to the mechanisms used in Organized Exchanges.
- More collateral will be needed for OTC derivative trading

Recent Regulatory and Supervisory Changes in EU and US: Leverage

- FED is proposing a minimum <u>leverage</u> ratio of 5% for GSIBS
- 6% for retail banks owned by a systemically important bank to be applied from 2018
- Swiss Banking regulators: %4+
- UK considers for leverage to deal with macropru.

Recent Regulatory and Supervisory Changes in EU and US

- ***Deposit Insurance in US:*** the federal government has permanently increased bank deposit insurance to 250,000$, which was only 100,000 USD before the 2008 financial crisis***.***
- *Selection of G-SIFI's and DSIFI’s*
- ***Leverage Ratio:*** an obligation on leverage ratio for relatively larger US banks.
  - US regulators consider a leverage ratio of 5% for banks with asset size>250 billon $
  - Swiss banking regulator considers 4.3% leverage in 2019
  - UK considers similar changes (use CET1 in the numerator rather than Tier 1)
- ***Establishment of the European Banking Authority (EBA)***
- ***Stress Testing Framework***

GSIB in Action

- HSBC and JP Morgan Chase appeared as bucket 4
  - required to hold 2.5% surcharge,

- Barclays, BNP Paribas, Citigroup and Deutsche Bank have been selected as 3rd highest SIFI
  - additional 2% capital charge.

Conclusion

- We are moving towards a stricter financial environment
- Is this time different than previous regulation regimes?
  - CCP, leverage etc.
- Regulation Cycle:
  - Regulation-De-regulation-...Regulation
    - But need to get ready for the regulatory and supervisory challenges