

## Some Considerations Regarding the Implementation of Basel III

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**Abstract** *Basel III represents a basic revision of the banking industry regulatory and supervisory framework for the future, the objective being the stability consolidation of the financial system. The objective of this article is to analyze the impact of the Basel III implementation upon the banking system at the European level, and respectively, upon the banking system of Romania. Basel III standards have been elaborated as a response of the 2008 financial crisis and are considered as vital for the assurance of financial institution capitalization against future financial shocks. The new standards have as an object the improvement of risk management, increased requirements of transparency and publication of credit institutions, as well as solving the banks problems of systemical importance. The measures that the credit institutions could adopt in order to mitigate the impact of alignment to the new standards are adjusting the business model and restructuring bank balance sheets.*

**Key words** Financial security, financial crisis, the banking system, Basel Committee on Banking Supervision, prudential requirements, risk management

**JEL Codes:** K20

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### 1. Introduction

Prolonged economic and financial crisis has been challenging for financial institutions, although those in Romania have been less affected because they were not exposed to toxic assets, but also because of prudential and administrative measures taken by the National Bank of Romania.

In the context of financial and economic crisis triggered in the European Union after the fall of 2008, the banking system in Romania also that in other European countries, faced with the consequences of decreasing standard of living, the purchasing power (in terms of retail) and with gaps and delays in payments occurred in the area of corporate clients.

All this led to deteriorating quality of bank investments, increased non-performing loans in total bank portfolios ultimately causing the accumulation of excessive risks to which banks were exposed. Amid the gradual collapse of European financial markets have

been increasingly debated aspects of factors have led to these consequences, disastrous at times of major European banks.

One thing is certain, namely that there were factors both at micro and macroeconomic who either acted independently or in connection caused the gradual erosion of quality and implicit confidence in the banking system. Impact of economic crisis acted as an "echo" on the banking system, as players in the business environment (both corporate and retail) faced increasingly more pronounced problems in the conduct of business partnerships.

## 2. Literature review

The risk assessment in the banking sector is briefly as follows: regulators established risk factors, according to which banks are required to keep a "safety margin" on a particular type of asset. Subprime crisis led to the fact that regulators have widened further in the risk assessment of bank assets which in principle is not necessary. Each bank has its own control system and risk assessment. Some are ineffective, other less. But this is normal, because the profitability of the bank and varies from one institution to another.

Meanwhile, Basel III changes involve quantitative, but qualitative and existing standards. One problem is to better integrate financial management processes of risk management. It takes time to establish smooth operation of existing systems and new systems should appear. It also raises issues and risk assessment for derivatives traded out of the organized market.

Adoption of the new standard will be accompanied by increasing capital requirements for banks, and in the case of the adoption of Basel III will be delayed in any country, the country's banking system will get an advantage over the banking systems of other countries.

Basel III reforms kit was developed by the Basel Committee on Banking Supervision to improve the regulation, supervision and risk management in the banking sector. Basel III rules require banks to hold capital in 2019 to rank first of at least 6% and total capital of at least 8%, following that with a capital buffer of 2.5% to reach a minimum of 10.5%.

## 3. Methodology of research

For the development work has used various research methods given the specific content of each chapter done. Using the scientific method to systematically address the subject studied patrimonial liability of credit institutions to arrive at knowledge tested and communicable to predictions that represent truths about this phenomenon.

The research covered various steps considered essential. Go to the most important stage: data collection, research the immediate investigation of concrete reality.

They analyzed quantitative and qualitative data obtained using research techniques suitable for the theme, namely: study of documents and internal regulations, international and European statistics, specialty papers, reports of institutions and organizations, etc. In investigating phenomena legal reform and transformation of the banking system were used, with predilection two categories: classical methodology and modern methodology.

Among traditional methods, using observation - as a form of information gathering general and neutral - with its variants:

- direct observation which were aimed directly both legislative aspects of current credit institutions and credit risk as well as implementation efforts the new regulatory framework Basel III Directive represented by both in Romania and in Europe is analyzed and recorded as objectively as possible the most important and significant;
- Indirect observation was used when findings were made based on previous observations (findings and personal observations);
- Participatory observation was used when in revealing the facts material to the phenomenon investigated; we directly involved other approaches were methods non-reactive as a group of methods of investigation very different that does not apply in researching the phenomenon or process itself but in researching certain consequences thereof.

#### **4. Data analysis**

Basel III Capital Accord introduces capital requirements quantitative and qualitative extensive new liquidity requirements, a review of counterparty credit risk and an indicator of indebtedness to banks in the member countries of the Basel Committee. The legal framework for the package Basel III governing the taking up, supervision and prudential rules applicable to credit institutions and be investment is being implemented gradually from 1 January 2014 to 2018.

The new regulations could cause low interest credit institutions on the financing representing a challenge including the banking industry's ability to achieve profit. A challenge is adapting banking groups' financial solvency and liquidity requirements imposed by Basel III provisions that could lead to the restriction of exposures and changing the business model.

Romanian Banking Association has made concrete steps the authorities, including the European Commission and the European Parliament to protect the interests of SME's and to be finally in the whole economy. Gradual adjustment capital requirements do not indicate, in a first stage, problems with the required capitalization Romanian banking system. Romanian banking system still has substantial reserves of capital. The solvency ratio remained at a high level of 18.07% in June 2015.

It gradually gives to be prudent during the implementation of the additional capital requirements of Basel III (between 2014-2018) by 20% annually. This calculation includes the effects of prudential. Level of the solvency calculated by excluding the prudential, is about 4 percentage points higher than the level reported in accordance with prudential regulations in force, according to BNR. This shows higher capital adequacy risks of many countries in the region. The new liquidity requirements should be reviewed in detail is to avoid any unintended consequences.

Credit institutions supporting the inclusion of minimum reserves (RMO) in the calculation of liquidity, given the size of the required reserve ratio applicable to liabilities to credit institutions 8% to 14% for lei and foreign currency, compared with a European average of 2%. Basel agreements are some of the most influential modern arrangements among international finance. Drafted in 1988 (Basel I), 2004 (BASEL II) and 2009 (BASEL III) BASEL I and II inaugurated a new era of cooperation International Bank will make BASEL III to harmonize banking and perpetuate cooperation as banks.

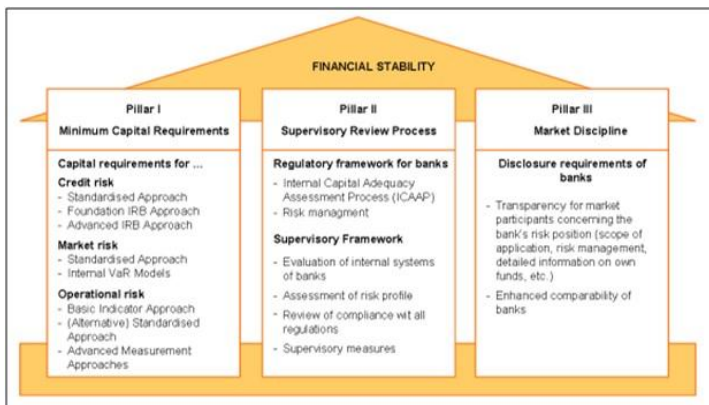


Figure 1. The Basel III Framework

Costs of banking crises are extremely high and, unfortunately, their frequency was too. Since 1985 there have been over 30 banking crises in member countries of the Basel Committee. Many countries may not have been the cause of the current crisis, but were affected in turn by the fall that took place globally. In addition, history has shown that these banking crises occurred in all regions of the world, affecting main business lines and asset classes.

Basel III reforms aim is to reduce the probability and severity of future crises. This will involve certain costs arising from a regulated capital liquidity stronger, better supervision and intense. The new standards BASEL III differ fundamentally from Basel I and Basel II, by having coverage to more extensive and that the measures are both micro (address individual risk of banks) and macro (intended risks manifested in the entire system banking).

On the micro, these reforms mean:

- improved quality of the capital base by increasing the Minimum Equity (ordinary shares, the financial result earnings and reserves) and the minimum requirement founds Tier 1 (equity and hybrid) and by introducing stricter criteria for eligibility for instruments that can be taken into account in determining Tier 1;
- Significant increase in the coverage of risks, focusing on areas that have been most problematic during the crisis, namely counterparty credit risk, securitization activities;
- Limiting leverage as a supplementary measure to the capital requirements calculated by risk regarding the micro, Basel III brings news to all three components of the equation capital: regulatory capital assets weighted according to risk and solvency ratios.

Regarding the definition of capital, Basel III puts emphasis on financing through the issuance of common shares. Thus reduce the list of financial instruments which constitute Tier 1 capital (tier 1) capital and removes rank 3 (tier 3).

It also introduces stricter rules of transparency in terms of capital. In terms of assets weighted according to risk, Basel III includes requirements for higher capital for trading activities in financial markets: assets for trading (trading book) products securitization credit risk for instruments traded OTC (products derivatives and repurchase agreements).

As a result, capital requirements for trading book are estimated to increase about four times compared to those required by Basel II. Regarding the solvency ratio under the new agreement, banks must hold 4.5 percent of risk-weighted assets according to the capital obtained from issuance of common shares (versus 2 for Basel II).

In addition, banks must hold all joint actions, a supplement (buffer) of 2.5 percent for the conservation of capital, leading to a common equity ratio of 7 percent. According to estimates by the Banking Supervision Committee of the Bank for International Settlements, new regulations lead to an increase (compared to Basel II) approximately seven times the capital requirements of joint action.

The new agreement increased tier 1 capital requirement of 4 to 6 percent and remain at 8 percent minimum capital ratio. A novelty brought by this agreement and action taken with regard to capital preservation. Thus, Basel III introduces a requirement for banks to maintain a capital buffer of 2.5 percent of assets weighted according to risk capital consists of the issuance of common shares. When capital ratio lowers capital buffer is

used to cover losses, and the agreement requires banks to retain a major share of revenues to reconstitute the capital and impose restrictions on the distribution of dividends, purchase of own shares and the granting of discretionary bonuses.

Also a novelty brought by the new agreement is the reference to the macro-prudential at the level of the banking system in an attempt to combat systemic risk. According to Committee on Banking Supervision of the BIS rate lever it has been introduced due to the fact that preceding the banking crisis, banks that reported capital ratios Tier 1 solids have also registered high levels of leverage the basis of operations included in the balance sheet and through off-balance sheet operations. Thus, the leverage ratio is calculated as a percentage of Tier 1 capital in assets and off-balance exposures and derivatives. If used derivatives exposure is regulated by the supervisory body plus a supplement for potential future exposures and netting site is allowed.

Basel II	Requirements	Basel III*
8%	Minimum Ratio of Total Capital to RWAs	10.50%
2%	Minimum Ratio of Common equity to RWAs	4.5% to 7%
4%	Tier 1 Capital to RWAs	6%
2%	Core Tier 1 Capital to RWAs	5%
None	Capital Conservation Buffer to RWAs	2.50%
None	Leverage Ratio	3%
None	Countercyclical Buffer	0% to 2.5%
None	Minimum Liquidity Coverage Ratio	TBD (2015)
None	Minimum Net Stable Funding Ratio	TBD (2018)
None	Systemically Important Financial Institutions Charge	TBD (2011)

\* Basel III requirements will be progressively phased-in over the next eight years.

Figure 2. BASEL III requirements

Regarding measures to combat procyclicality under the new agreement, each supervisory authority shall monitor credit developments in relation to GDP, and based on their own assessment, if they consider credit growth as excessive and likely to pose risks to the entire banking system, bring an additional capital requirement (cyclical buffer) between 0 and 2.5 percent of common shares corresponding capital. This requirement can be reversed when the risk to the banking system ceases. If a bank operating in multiple jurisdictions buffer capital will be a weighted average according to the exposure on loans to these requirements in each jurisdiction in which we operate. To give banks sufficient time for adjustment, amendment countercyclical capital requirements must be announced 12 months before the entry into force of the requirement. The new Basel III aims to strengthen the banking system stability by applying stringent standards designed to improve the capacity it to absorb shocks from the economic and financial sectors, and to reduce the risk of contagion from the financial sector to the real economy.

The new standards take into account the improvement of risk management, increased transparency and disclosure requirements of credit institutions and to solve problems systemically important banks. The measures require, first, higher standards for banks on capital adequacy, liquidity requirements and leverage, the main goal being reducing the negative effects of financial crises. Basel III represents a fundamental overhaul of the regulatory framework and supervision of the banking industry in the future, the aim being strengthening financial system stability. Basel III rules were developed in response to the financial crisis of 2008 and are considered vital to ensure the capitalization of financial institutions against future financial shocks.

Established in 2010 by a committee of central banks and regulatory bodies around the world, the rules of Basel III would require banks to build up reserves equivalent to 7% of the loans they grant, compared to 2% today. Credit institutions will react differently to the new standards, according to the transition period needed to fulfill requirements. If the transitional period is shorter, banks may prefer reducing the supply of credit in order to increase the level of capital and alter the structure of assets.

Gradual implementation of the new standards can mitigate the impact of banks being able to adapt by capitalization of profits, issuing shares, changing the structure of liabilities. Banks should strive to improve the ability to transfer risks. One way is closer cooperation between the bank and the agency's creative product, so both teams are committed to increasing the volume of loans that can be securitized, sold or syndicated. Another way to transfer risk to the bank is expanding partnerships on issues of syndication and securitization, both geographically and by industry.

## **5. Conclusions**

Implementation of Basel III standards specific to the Member States of the time this involves preparing the national banking system. First, the domestic banking sector by policy makers at the central bank and credit institutions must know the provisions of the new agreement.

It must then assessment of the current state of development of the banking system and, not least, configuration and implementation of a coherent set of measures to adapt to the domestic banking system, enabling the future implementation of Basel III.

In conclusion, Basel III is more than just another set of regulations, and testing its provisions affecting fundamentally banking industry's ability to produce profit.

At the micro-reforms level in order to increase the resistance of individual banking institutions to periods of stress and, respectively, the level of macro - in order to reduce the frequency of financial crises.

The new standards are designed to improve the banking sector's ability to absorb shocks through superior risk management under the coordinates of an enhanced governance and increased transparency conditions. We believe that careful

consideration is needed and a final decision before launching structured Basel III required.

The regulations will always have completed, to protect banks that have good financial standing to protect public funds and taxpayers, protect depositors and customers, to guarantee the real economy to have access to credit, not strangle innovation - the source of progress.

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