Mahendra Vikramdass Punchoo: The impact of Basel III reforms in the implementation of Basel II/III in emerging market and developing economies

Speech by Mr Mahendra Vikramdass Punchoo, Second Deputy Governor of the Bank of Mauritius, on the Impact of Basel III reforms in the implementation of Basel II/III in Emerging Market and Developing Economies, Port Louis, 24 July 2018.

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The Director of AFRITAC South, Ms Effie Psalida

The Resident Adviser AFRITAC South, Mr Ravi Mohan

Ladies and Gentlemen,

A very Good Morning to you all.

Last year, in August, I delivered a speech on the same topic and at the same venue. The seminar was so successful and I recall that many participants expressed interest that such seminars feature again in the annual work programme of AFRITAC South. I am happy that AFRITAC South has obliged, giving this opportunity to as many participants as possible. Such high-level exposures to the intricacies of Basel III do not come spontaneously to us in this part of the World given the relative unsophistication of our banking system and limited experience.

That so many high-calibre technical experts should fly down to Mauritius is in itself a testimony of the commitment the International Monetary Fund, through the presence of AFRITAC South, has towards member countries in promoting best practices in the business of regulation and supervision of banks.

Under Basel II banks had too little capital and were highly leveraged. Their incentive to take risks was disproportionately high. The flexibility given to these banks under the internal ratings-based approach for credit risk had led them to significantly under-estimate the risk-weighted assets so much so that banks with similar portfolio, risk profile and business models had widely dispersed risk-weighted assets. In addition, their increasing reliance on the interbank market to fund assets made them vulnerable to a liquidity squeeze.

Basel III has not only improved the quality of the capital that banks are required to hold but also increased the capital requirements. Higher quality capital in the form of Common Equity Tier 1 capital and comprising mainly of equity and retained earnings, has been raised from 2 per cent to 4.5 per cent of the risk-weighted assets while Tier 1 capital has been increased to 6 per cent. To deter banks on the IRB approach from taking undue advantage of the model-based approach to credit risk, Basel III has introduced a floor for risk-weighted assets. For banks under the standardised approach to risk-weighted assets, Basel III determines a more detailed risk weighting and lesser reliance on external credit ratings.

Banks are also required to hold “capital conservation buffers” of an amount equal to at least 2.5 per cent of the risk-weighted assets, in the form of CET1 capital, which would be available in times of stress. However, the minimum level for total capital requirements remains at 8 per cent of risk-weighted assets. In addition, banks would have to keep a Leverage Ratio as a percentage of total assets inclusive of off-balance-sheet items such as derivatives and letters of credits to constrain their debt build-up. Finally, banks would have to keep a countercyclical buffer from their retained earnings during periods of high economic growth to even out any stress on their capital during periods of economic downturns. In the case of global systemically important banks (G-SIBs), they would be subject to additional capital requirements.

In effect, these higher common equity requirements would undoubtedly incentivise shareholders, investors and senior management including Board of Directors to take less risk.

Liquidity risk, implicitly covered in Pillar 2 under Basel II, is a stand-alone risk requirement under Basel III. The liquidity risk is addressed by the introduction of the Liquidity Coverage Ratio, which would provide banks with enough high-quality liquidity instruments for 30-days in the event of stressed conditions, and the Net Stable Funding Ratio for stressed liquidity conditions of up to one year. Both the LCR and the NSFR seek to reduce the excessive mismatch of banks' assets and liabilities structure.

In Mauritius, Basel III implementation has been a gradual process. Prior to July 2014, the year Basel III was introduced, banks in Mauritius had to maintain a 10 per cent minimum capital adequacy ratio consisting of a ratio of 5% Tier 1 capital and a similar ratio of 5% Tier 2 capital to risk-weighted assets. Tier 1 capital consisted of equity, general reserves, statutory reserves (15%) and retained earnings. Tier 2 capital, limited to 100% of Tier 1 capital, consisted of subordinated debt of maturity of at least 5 years, which can only be redeemed after approval has been received from the Regulator, revaluation reserves with a 55% haircut and other instruments as may be approved by the Regulator.

Under Basel III, Tier 1 capital to risk-weighted assets has been set at 8% with CET1 capital to risk-weighted assets set at 6.5 % while the minimum capital adequacy ratio has been maintained at 10%.

The migration to Basel III capital requirements did not prove challenging as around 90% of the banks' capital base was already in the form of Tier 1 capital. In addition to the capital adequacy ratio, the Bank of Mauritius introduced a capital conservation buffer of 2.5%, with its implementation staggered over a period of 4 years. A first tranche of 0.625% became effective on 1 January 2017 and thereafter on every 1 January, the capital conservation buffer would increase by a tranche of 0.625% until it reaches 2.5% on 1 January 2020.

In lieu of the counter-cyclical capital buffer, the Bank of Mauritius introduced macro-prudential measures to limit the build-up of risks in three key economic sectors, which had witnessed unprecedented growth rates. These measures took the form of additional portfolio provision and higher risk weights for specific categories of exposures as well as debt-to- income ratio and loan-to-value ratio (LTVs were removed effective 6 July 2018).

In June 2014, the Bank of Mauritius introduced a Guideline for dealing with domestic-systemically important banks, which set out the methodology for assessing the systemic importance of banks. In addition to four parameters identified by the BCBS namely, size, interconnectedness, complexity, and substitutability, a fifth indicator identified as the exposure to large groups was added to the annual assessment to reflect a specific concern about the Mauritian economy. The capital surcharge, determined to be in the range of 1.0% – 2.5% for the five banks identified as D-SiBs has been effective as from 1 January 2016 and would be implemented over a four-year period to give the D-SIBs ample time to meet the enhance capital requirement.

There are many factors, which explain why banks in Mauritius are required to maintain a higher minimum capital adequacy ratio of 10% compared to the BCBS recommended 8%. First, in the absence of an effective and efficient capital market, banks are the main credit providers in the economy and bank failures usually adversely affect the economy. A higher capital adequacy ratio provides a greater insurance against risks. Second, the recovery process of non-performing loans entails unduly long and costly court procedures; and third, market risk may turn out to be a significant risk given the lack of depth and breadth of financial markets. Over and above these considerations, banks may voluntarily hold a higher capital adequacy ratio if they want to maintain or even improve their credit ratings, especially if they intend to access the international capital market. Two internationally credit-rated banks in Mauritius have CAR well above 10%.

With respect to the implementation of the Liquidity risk requirements, the Bank of Mauritius reviewed its Guideline on Liquidity Risk Management in October 2017 to incorporate the Liquidity Coverage Ratio. By virtue of Mauritius being a regional financial centre, banks were required to maintain the LCR by major currency. Effective 30 November 2017, banks should maintain on a monthly basis an LCR of 100 per cent in MUR, 60 per cent in each significant currency and 60 per cent on a consolidated basis. The LCR requirement in each significant foreign currency and on a consolidated basis was increased to 70% on 31 January 2018 and will be gradually increased every year to reach 100% by 31 January 2020. Largely due to the prevailing excess rupee and foreign currency liquidity, the average LCR for the banking sector in MUR, USD, EUR and CNY as at 31 April 2018 stood at 266%, 108%, 77% and 83% respectively. On a consolidated basis, the average LCR for the banking sector was 174% as at End-April 2018.

A higher CAR and appropriate liquidity do not on their own guarantee zero risk of failure. Best practices in corporate governance and good risk management practices are complementary actions favoured by the Regulator.

Let me conclude with four remarks, which you may wish to reflect upon:

The first remark is about the growing recognition that the “one-size-fits-all” regulatory framework may not be optimal. Increasingly, in several countries, the principle of proportionality in regulation is being discussed and implemented. What is meant for internationally active banks may not or should not be indiscriminately applied to all! While there seems to be a strong case for proportionality in regulation – banks with simple business models should not fully implement Basel III -, it is not at all simple to decide which features of Basel III should not apply and which features should apply. Generally, proportionality in regulation tend to be an outcome of a risk-based approach to regulation.

The second remark is about the unintended consequences of stringent capital requirements of Basel III. One European bank has already exited Africa, including Mauritius. Two others are in the process of exiting the Mauritian jurisdiction as the Group review the business models, refocus operations on their core markets, cut down costs by running down their less profitable and non-core business lines, reducing their geographical footprint and investing heavily in technology to optimise capital within Group.

A case in point is the divestiture of Barclays Plc in Barclays Africa Group Limited. Barclays in Africa was a successful story of over 100 years which is about to end not because it was not profitable – Barclays Africa generated nearly £1 billion profit before tax in 2015 – but because, according to its Group CEO, of increased CET1 requirements by the UK regulatory authority, G-SIB Buffer, TLAC, and the UK Bank Levy. In the Barclays CEO’s review for the Annual report 2015, Barclays Africa has become “non-viable economically under current regulatory capital rules”. He further writes “Barclays UK has to carry 100 per cent of the financial responsibility for Barclays Africa and receive only 62 per cent of the benefits.” It is worth noting that Barclays UK has also exited its retail banking operations in Italy, France, and Pakistan and sold its Wealth & Investment Management business in Singapore and Hong Kong.

The third remark relates to the unintended consequences of the introduction of the Liquidity Coverage Ratio. Basel III restrictively defines liquidity as an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted easily and immediately in private markets into cash to meet liquidity needs for a 30 calendar day liquidity stress scenario. In Mauritius where there are not enough liquid assets, banks have to keep large amounts of cash with the central bank at zero interest rates instead of interest-earning placements with banks abroad. In turn, this could adversely impact customers with banks charging higher fees, charges and commissions.

The fourth and final remark relates to the impact of Basel III Rules on Trade Finance. Basel III could significantly undermine cross-border trade finance activities. Several provisions of Basel III,

such as the leverage rule, risk weighting requirements and the liquidity rules raise the costs of banks' extending trade finance, which is already a low margin business. The leverage ratio requires banks to hold top quality tier one capital equal to 3% per cent of their total assets, including off-balance sheet assets such as trade finance commitments. In addition, because trade finance involves the importer's bank and the exporter's bank through a letter of credit, the changing risk weight on loans between financial firms is likely to adversely affect trade finance. Finally, the liquidity rules, which require banks to match long-term obligations with long-term funding could also penalise trade finance.

I thank you for your attention and wish you the best.