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Expert Analysis

Basel III Adoption— Slow Going in Many Jurisdictions

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The Group of Twenty, also known as the G20, is a group of Finance Ministers and Central Bank Governors representing the world's largest economies and works for international cooperation in the area of international economic and financial issues. The G20 has been very supportive of the implementation of the enhanced capital standards for banking institutions issued by the Bank for International Settlement's Basel Committee. After its meeting on June 18-19, 2012, in Los Cabos, Mexico, the Leaders of the G20 issued an ambitious set of recommendations that the group felt would strengthen the global economy, address tensions in the financial markets and promote job growth.[1] One of the recommendations was to urge jurisdictions to finalize adoption of Basel II, Basel 2.5 and Basel III, standards which are all aimed at strengthening capital at banks on a global basis.

The Basel Committee has been issuing periodic reports to the G20 on implementation of the new capital accords. The most recent set of reports was issued in anticipation of the G20's most recent meeting on Nov. 4-5, 2012, in Mexico City.[2] After the meeting, the G20 issued a communiqué reporting on progress in acting on the recommendations that had been raised at the June meeting in Mexico City. The G20 endorsed the latest Basel Committee report and agreed to "take the measures needed to ensure full, timely and effective implementation of Basel II, 2.5 and III and its consistency with internationally agreed standards."[3] This month's column will discuss those reports and progress on international implementation of the strengthened capital standards.

A Little Background

Previous columns have discussed what are known as Basel II, Basel 2.5 and Basel III capital requirements.[4] Basel III's origins are in the most recent financial crisis and addressed changes on a global basis to stabilize the markets and the global financial system. Highlights of Basel III include the imposition of a leverage ratio, the establishment of a specific liquidity requirement and a strengthening of a bank's Tier 1 (core) capital requirements by mandating that common equity be the predominant component of Tier 1 capital.

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The Basel Committee had set Jan. 1, 2013, as the beginning of the transitional period to full implementation of Basel III. However, as the Basel Committee reports show, there still is much progress that needs to be made. By Jan. 1, 2013, countries are supposed to have adopted final statutes or regulations that would begin to go into effect on that date. At the time of the Basel Committee's issuance of its latest progress report on Oct. 29, 2012, only eight of the 27 member jurisdictions[5] on the Basel Committee had issued final sets of Basel III regulations by the end of September, while 17 members had published draft regulations and two countries still were drafting proposed regulations but had not yet published them.

The Basel Committee particularly has been urging countries which are home countries for banks that are considered to be global systemically important banks (G-SIBs) to move quickly to finalize their capital regulations because many of the reforms are aimed specially at ensuring stability at such institutions. The United States and the countries of the European Union, home countries to many of the G-SIBs, are lagging behind in full implementation. However, preliminary to adoption of Basel III, it was necessary for each country to have adopted Basel II, which was a comprehensive reworking of the original Basel I capital standards and was supposed to have been adopted in full by the end of 2007. In addition, countries also should have adopted Basel 2.5, issued by the Basel Committee in July 2009, which focuses on, among other areas, regulatory capital standards for securitization and trading book capital. As noted below, the Basel Committee in its Oct. 29 report to the G20 was able to report better progress in those areas.

The Basel Committee also has a three level plan to evaluate the final regulations adopted by the member countries. Level 1 tracks the progress of Basel Committee member countries towards full compliance with Basel III. Level 2 analyzes the regulations adopted by each country against the standards set forth by the Basel Committee in Basel III. Level III will evaluate the consistency in outcomes, such as risk-weighted assets, on a country level. Level 1 was the subject of the recent set of reports issued in advance of the G20 meeting so that the G20 could evaluate progress on implementation. At the same time, the Basel Committee also issued Level 2 regulatory consistency reports on the final rules in Japan, and on the draft rules in the United States and the European Union. Level III evaluations still are in progress.

Countries in Full Compliance

According to the Basel Committee report to the G20, most of the Basel Committee members are in compliance with Basel II, with some countries, such as the United States, still in the process of full implementation. As for Basel 2.5, again most

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of the member countries have adopted these requirements, although some are still in the drafting stage (e.g., Argentina), and some have final regulations due to come into force on or before Jan. 1, 2013 (Saudi Arabia).

Turning to Basel III, as noted above, eight of the Basel Committee member jurisdictions have published final regulations to implement Basel III (Australia, China, Hong Kong SAR, India, Japan, Saudi Arabia, Singapore, and Switzerland) and most of the rest have issued draft regulations but not yet adopted them (e.g., the United States and the countries of the European Union). However, two countries have yet to start the process of even issuing draft regulations (Turkey and Argentina).

Adoption of Basel III final rules does not mean that the country adopted the rules in full uniformity with the Basel III standards released by the Basel Committee. Consistency with the standards will be the focus of the Level II review by the Basel Committee. To date, the Basel Committee has issued one Level II report, on Japan, which was found to be compliant with no material deviations from the standards issued by the committee. The Basel Committee plans to issue several more Level II reports in 2013.

European Union, United States

The European Union (of which several Basel Committee members are a part) and the United States still are in the draft regulation phase, and the Basel Committee feels that it is particularly urgent that these countries, home to many G-SIBs, promptly finalize such regulations. However, it appears that as of now, come January 2013, final rules will not be in force in either jurisdiction.

With respect to the European Union, it had implemented Basel I, II and 2.5 capital requirements as individual Capital Requirements Directives, which required that each EU member country had to adopt them on a country by country basis. The European Union is proposing implementation of Basel III through a Capital Requirements Regulation that would not need to be adopted individually by each EU member country in order to be effective. A draft European Parliament Legislative Resolution was agreed on May 14, 2012, and as of late September, the European Parliament, Council and Commission still were working on a final text of the regulation.

With respect to the United States, it still is in the final adoption phase of Basel II, with possibly more changes being made as a result of its implementation of Basel III. Basel II final regulations in the United States include only the Basel II advanced approaches allowing use of proprietary internal models approved by the regulators, and are mandatory only for the largest and most complex financial institutions. The United States did not offer the option of the Basel II standardized approach, which is similar to the original Basel I capital standards in the sense that it utilizes a specified risk matrix in determining risk-based capital.

In June 2012, the U.S. bank regulators issued proposed rules to fully implement Basel III, and the comment period ended only on Oct. 22. More than 1,000 comments still are being reviewed. Unlike the application of Basel II to only the largest and most complex banking organizations, many of the proposals issued for comment are applicable to all banking organizations. In addition, the adoption of Basel III also must take into account certain capital requirements that were included in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which mandated the adoption of minimum risk-based and leverage capital requirements for all banking organizations. Community banks in particular have complained that the regulations have an unnecessarily burdensome effect on them and must be revised.

As of last week, the Jan. 1, 2013, date for implementation set by the Basel Committee was looming, but the U.S. regulators still had the enormous task of finishing their analysis of the comments, making revisions and issuing the final rule with enough time for the banking organizations to fully implement it. Accordingly, on Nov. 9, 2012, the U.S. banking regulators issued a release calming the collective nerves of the U.S. banking industry by stating that the agencies did not expect that any of the proposed capital rules would become effective on Jan. 1, 2013, and that it would take into account "operational and other considerations" in setting implementation dates and transition periods. Acknowledging its role as an important global bank regulator, it stated that "As members of the Basel Committee on Banking Supervision, the U.S. agencies take seriously our internationally agreed timing commitments regarding the implementation of Basel III and are working as expeditiously as possible to complete the rulemaking process."

Beyond Member Compliance

Finally, it is not just the Basel Committee member countries that have adopted some of the Basel standards and are working on adopting Basel III. The Financial Stability Institute, also part of the Bank for International Settlements, surveyed Basel III adoption in 70 countries that are not members of the Basel Committee. The survey covered a wide range of countries—small island countries (Bermuda, Bahamas and the Virgin Islands) and countries in the Middle East (Kuwait, Lebanon and Egypt), South America (Bolivia, Chile and Peru) and Europe (Iceland, Norway and Lichtenstein).

The Financial Stability Institute issued its own report in July 2012, using the same review methodology as used by the Basel Committee in evaluating compliance by Basel Committee members in reviewing the implementation of Basel III in its own members.[6] Most of the countries surveyed still are in the process of drafting proposed regulations. The report provides an excellent source for people seeking information on bank capital standards applicable to these 70 countries.

Conclusion

Basel III, developed as a result of the most recent 2008 financial crisis, is aimed at shoring up global capital and liquidity standards that one would hope would enable the banking industry, particularly large, internationally active and systemically significant banks, to better weather any future crisis without needing government bailouts or takeover. Full implementation is several years away, but the sooner the G-SIBs in particular adopt Basel III and begin implementation, the better it will be for the global financial system.

1. "G20 Leaders Declaration," June 19, 2012, available on the G20's website, www.g20.org.
2. See "Report to G20 Finance Ministers and Central Bank Governors on Basel III implementation," and related documents, Basel Committee on Banking Supervision, October 2012, all available on the website for the Bank for International Settlements, www.bis.org.
3. "Communiqué of Ministers of Finance and Central Bank Governors of the G20," Nov. 5, 2012, available on the G20 website, www.g20.org.
4. See, for example, Kathleen A. Scott, "Paying Attention to Proposed Capital and Liquidity Requirements," New York Law Journal, March 10, 2010; "New International and Capital and Liquidity Requirements," New York Law Journal, Jan. 12, 2011; and "'Capital' Update: Surcharge Proposed on Banks Posing Greatest Risk," New York Law Journal, July 13, 2011.
5. The member countries of the Basel Committee are Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, (South) Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.
6. The Report, "FSI Survey: Basel II, 2.5 and III Implementation," July 2012, is available on the BIS website.