



# The Challenges of Basel III for the Czech banking sector

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## 2. The global context of CEE

## 3. Basel II and III

## 4. Basel III in the Czech banking sector

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## 6. Conclusion



# Will Basel III be effective regulation?

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- Regulation of financial markets remains a big challenge
- Failure of Basel II due to poor institutional framework and non-transparent regulatory process through the BIS -> risky “profitable“ behaviour of banks
- Basel III seems to have improvements but will it be sufficient?
- Strong and resilient position of the Czech banking sector -> not significant impacts of Basel III assumed (except for trade finance products)

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## 2. The global context of CEE

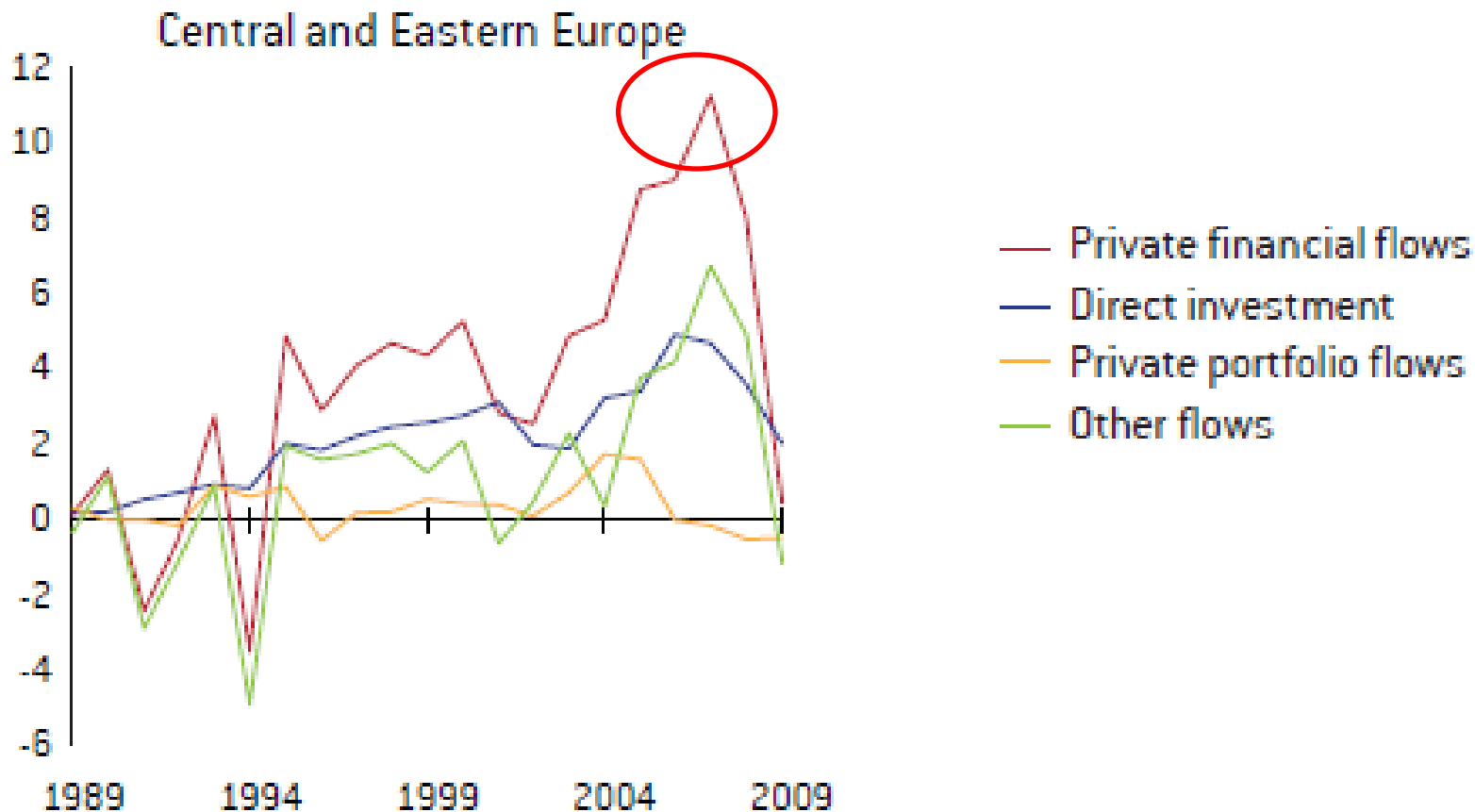
### Deep integration of CEE countries to the EU

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- 1) Huge net capital inflows before the crisis
- 2) Foreign ownership of CEE banks
- 3) Sharp increase of gross external assets and liabilities
- 4) High openness of CEE countries

## 2. The global context of CEE

### 1) Huge net capital inflows before the crisis (% of GDP)

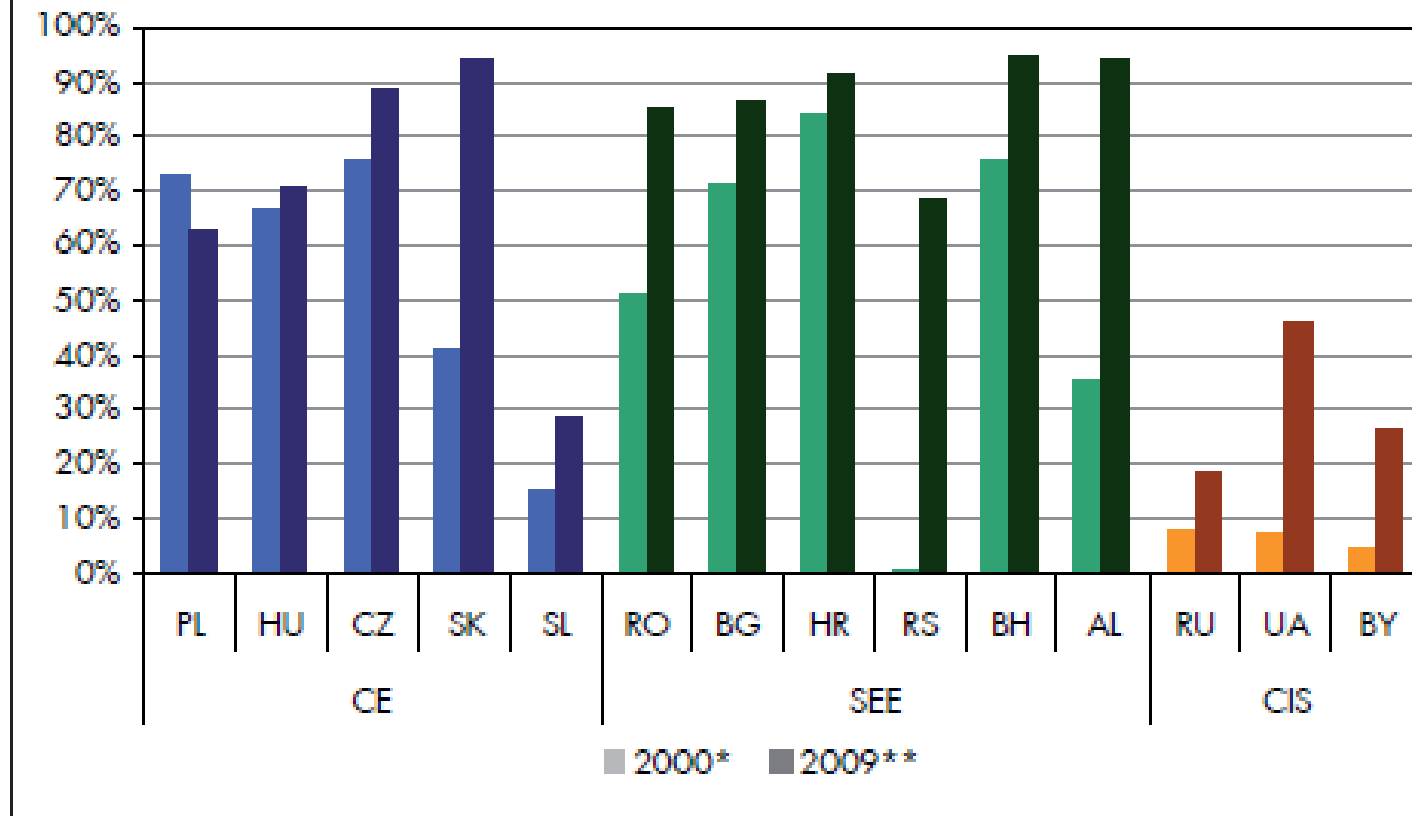


Source: WIIW & Breugel (2010)

## 2. The global context of CEE

### 2) Foreign ownership of CEE banks

#### Market share of majority foreign-owned banks

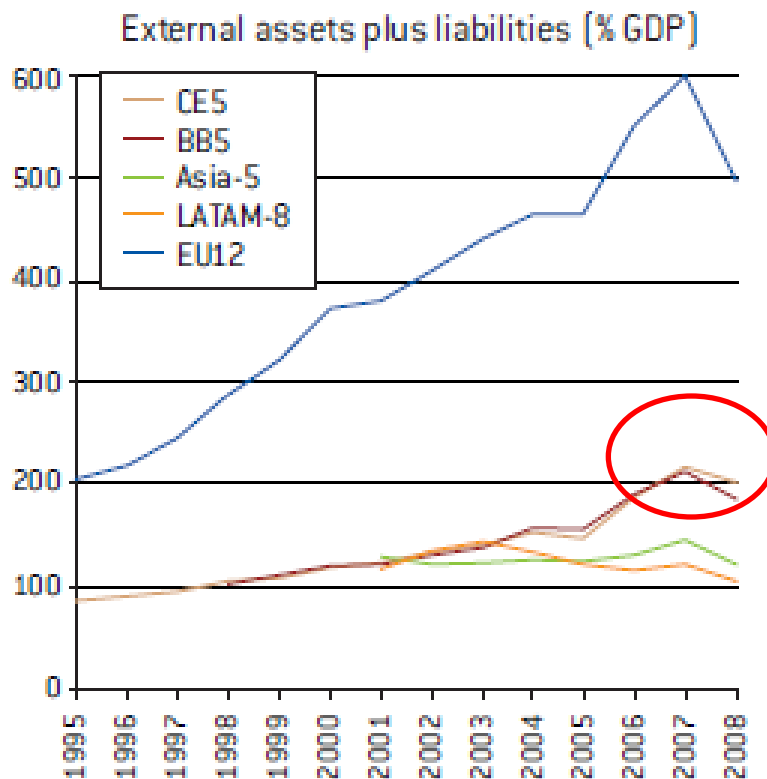


Per cent of total banking assets

Source: Local central banks, Raiffeisen RESEARCH

## 2. The global context of CEE

### 3) Sharp increase of gross external assets and liabilities

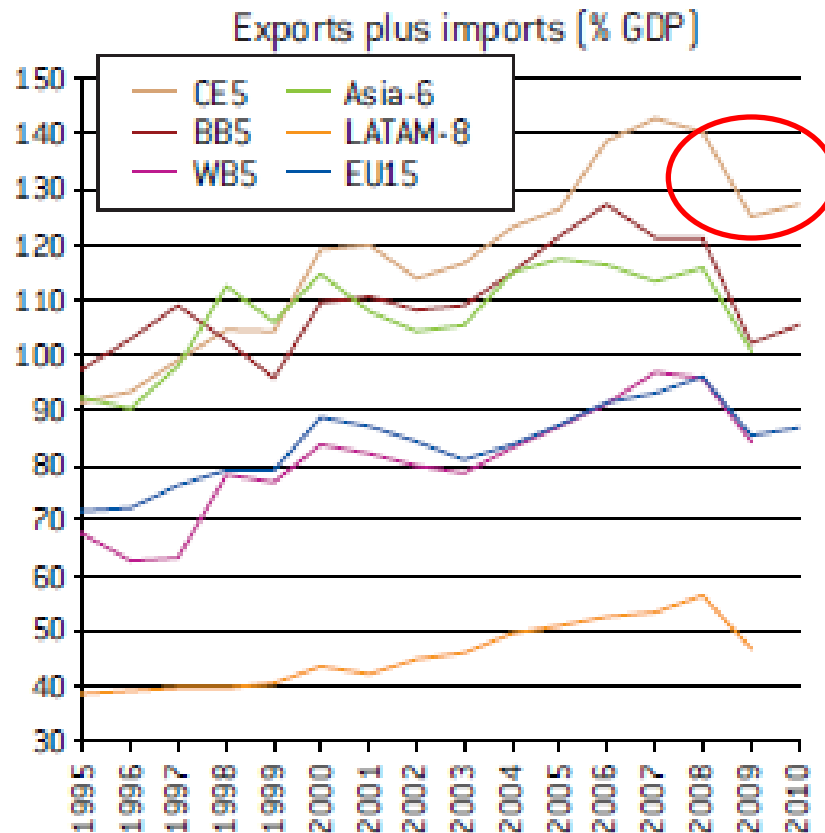


Source: Authors' calculation using data from IMF and UNCTAD.

Note: External assets and liabilities are not available for the full period for Greece, Ireland and Luxembourg and therefore the right-hand panel shows the average for the other 12 EU15 countries. Data is generally not available for western Balkan countries.

## 2. The global context of CEE

### 4) High openness of CEE countries



Source: Authors' calculation using data from IMF and UNCTAD.

## 2. The global context of CEE

# Sovereign risk of EMU countries now reflected in interest rates!

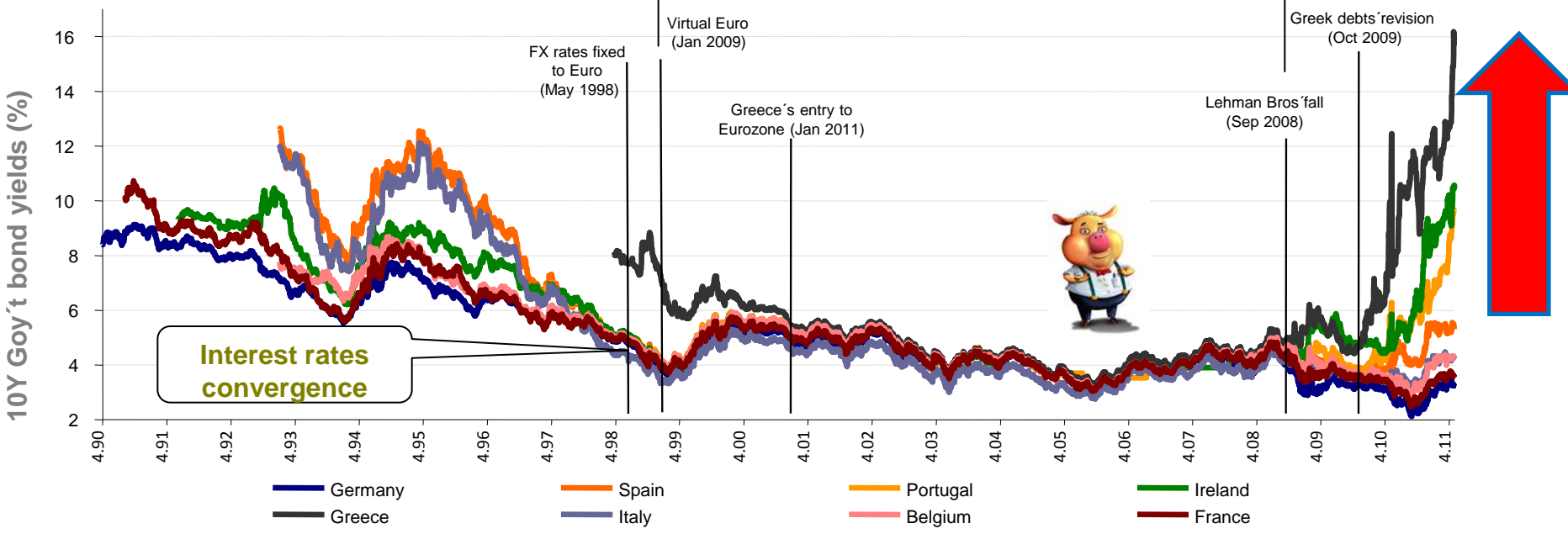
Investors distinguish risk  
Sovereign risk =  
FX risk + credit risk



Investors do not distinguish  
No FX risk -> PIGS as  
“safe heaven”  
Underpricing risk!



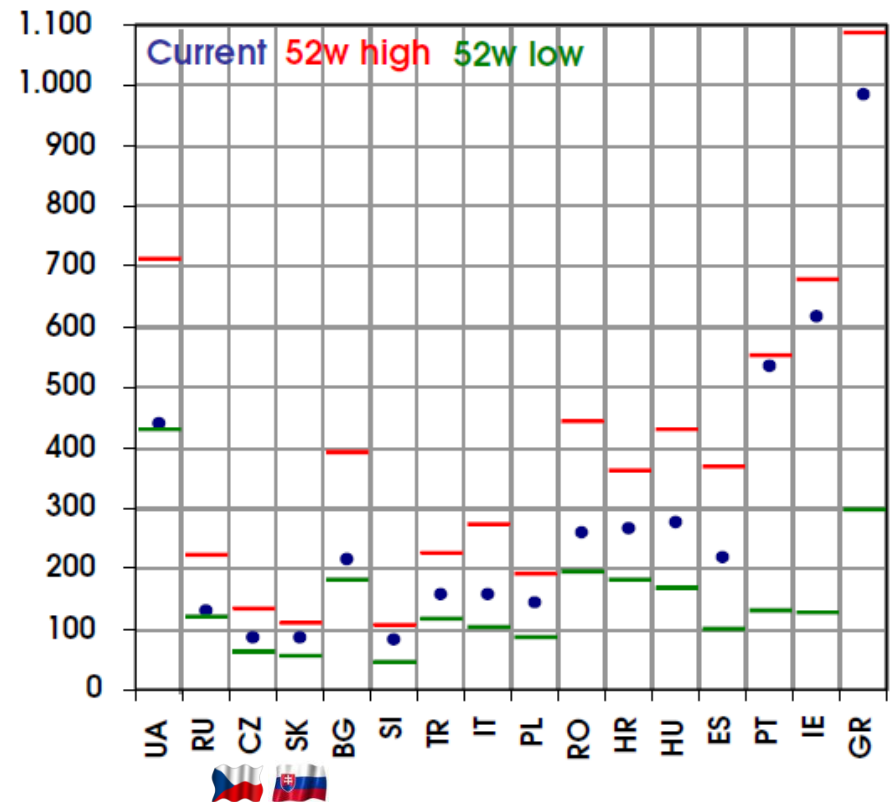
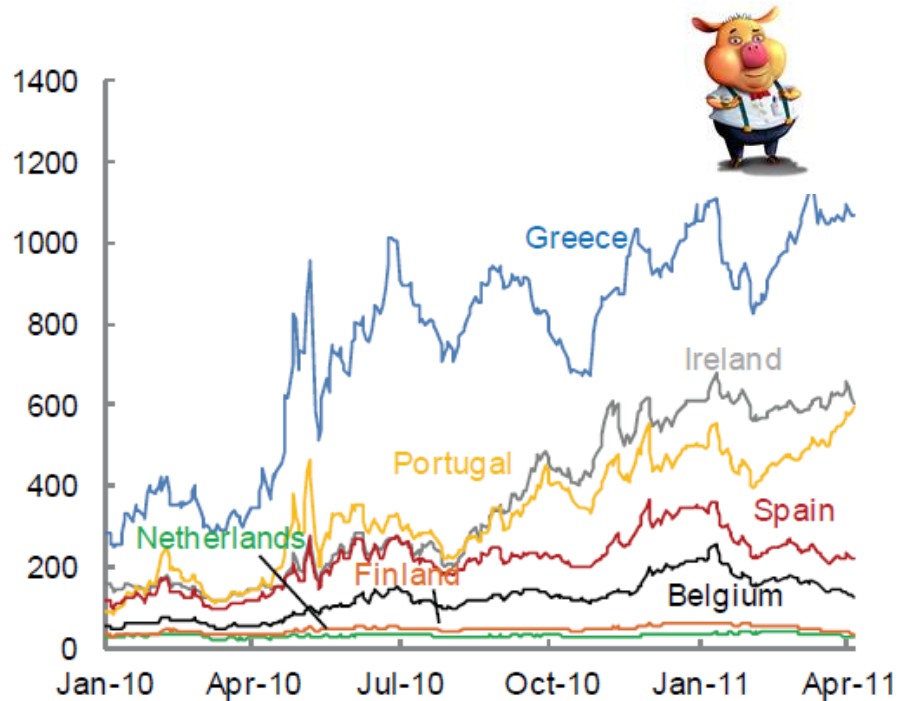
Investors distinguish risk again!  
In credit risk



Source: EEIP based on Kohutikova (2011)

## 2. The global context of CEE

### Now relatively low credit risk of CZE and SLK vs. PIGS!



➤ Credit Default Swap Spreads (basis points)

➤ Sovereign CDS (basis points), Countries sorted by distance to 1Y (April 2011)

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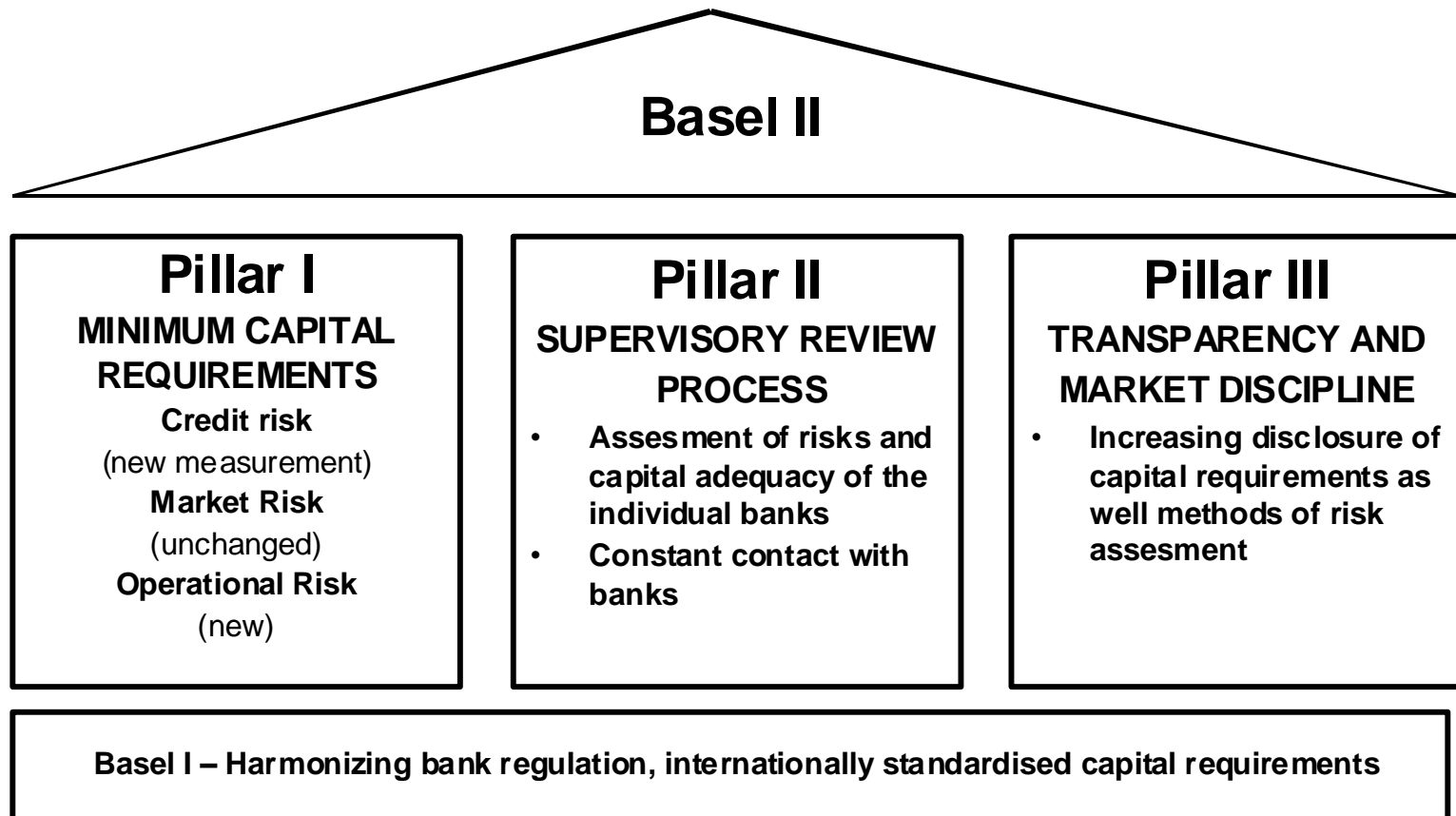
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# 3. Basel II and III

## Three pillars of Basel II

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\*Except for interest rate risk in the banking book.

### 3. Basel II and III

#### Critique of Basel II by Mejstrik(2004), Mejstřík & Pečená & Teplý (2008)

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- 1) tendency towards procyclicality; the more the regulation is risk sensitive the higher is the procyclicality effect.
- 2) Assymmetric Information in modelling (reg vs. bank)
- 3) Modelling based around quasi weak EMH form but future projects impact often based upon business intelligence from non-structured information
- 4) lack of the explicit implementation of other risks (e.g. liquidity or systemic risk);
- 5) an excessive use of external ratings;
- 6) an excessive prescription of the document (Pillar I vs. Pillar II vs. Pillar III);
- 7) difficult quantification of operational risk (NINJA loans, predatory lending etc.)

### 3. Basel II and III

## Critique of Basel II (Dewatripont et al, 2010)

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- 1) Inability to measure the individual risk of a bank failure
- 2) Inability to anticipate systemic risk
- 3) Inability to manage financial innovation



### 3. Basel II and III

## Critique of Basel II (Dewatripont et al, 2010)

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- 1) Powerful and independent banking supervisor – no correction to bank-regulator
- 2) Much simpler and easier to apply prudential regulation
- 3) The installation of a prompt corrective action regime for the management of crises, including a special resolution regime for systematically important financial institutions

### 3. Basel II and III

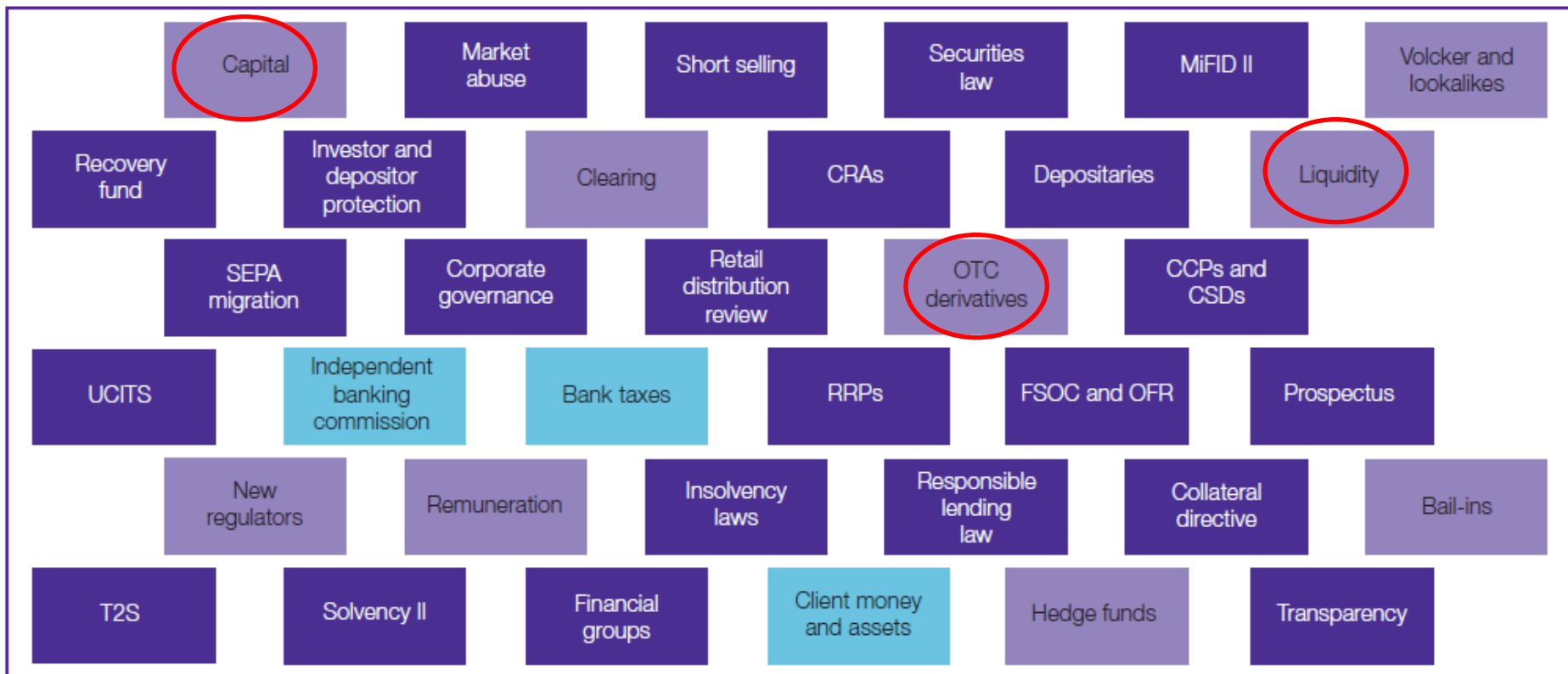
## Risk coverage evolution in Basel accords

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### 3. Basel II and III

## Challenge to regulation of world financial markets...



### 3. Basel II and III

#### Basel III proposal (December 2010)

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- 1) requirements for higher quality, constituency and transparency of banks' **capital** and risk management (implementation period in 2013-2019)
  - 2) introduction of new **liquidity standards** for internationally active banks
  - 3) focus on **systemic risk and interconnectedness** (including procyclicality and regulation of OTC markets)
- ? Global rules vs. US, China absence (keep 5% of originated assets only by some originators)
-

# 3. Basel II and III

## Key components of Basel III

	Basel 3	
Capital reform	Liquidity standards	Systemic risk and interconnectedness
Quality, consistency and transparency of capital base	Short term: liquidity coverage ratio (LCR)	Capital incentives for using CCPs for OTC
Capturing of all risks	Long term: Net stable funding ratio (NSFR)	Higher capital for systemic derivatives
Controlling leverage		Higher capital for inter financial exposures
Buffers		Contingent capital
		Capital surcharge for systemic banks

Source: KPMG (2010)

### 3. Basel II and III

## Basel III proposal (timing & implementation)

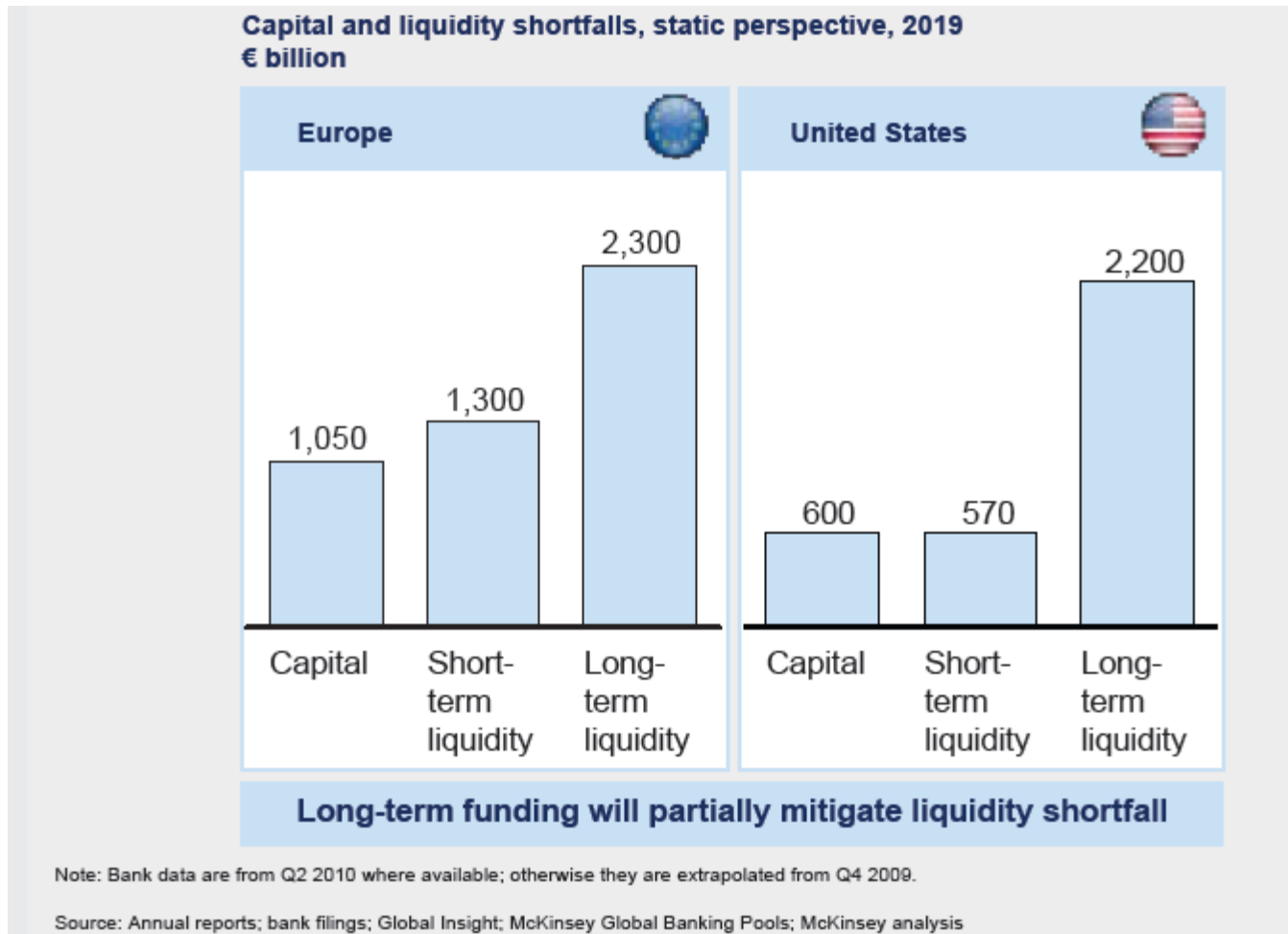
☐ Top priority<sup>1</sup>

	Key elements	Timeline	
		Processes and IT implemented; readiness to report to regulator	Full compliance required
<b>Capital</b>	New market-risk and securitization framework	Jan 2012	Jan 2012
	Counterparty credit risk	Jan 2013	Jan 2013
	Minimum core Tier 1 ratio	Jan 2013 <sup>2</sup>	Jan 2015
	Capital quality	Jan 2013 <sup>2</sup>	Jan 2022
	Capital deductions	Jan 2014 <sup>2</sup>	Jan 2018
	Conservation buffer	Jan 2016 <sup>2</sup>	Jan 2019
<b>Leverage</b>	Leverage ratio	Jan 2013 <sup>3</sup>	Jan 2018
<b>Liquidity/funding</b>	Liquidity coverage ratio	Jan 2013 <sup>4</sup>	Jan 2015
	Net stable funding ratio	Jan 2014 <sup>4</sup>	Jan 2018
<b>Remuneration</b>	Supervisory review of new remuneration policies	Jan 2011	Jan 2011
<b>Risk IT</b>	New requirements on risk IT	Detailed regulation in discussion	

<sup>1</sup> Processes and IT to be implemented before the end of 2012.  
<sup>2</sup> Reporting of first increase during transition.  
<sup>3</sup> Monitoring period starts in 2011 (regulator to track underlying components and resulting ratio).  
<sup>4</sup> Not yet clear when regulator will require reporting of these ratios (dates are estimates from experts); observation period for liquidity coverage ratio starts in 2011 and for net stable funding ratio in 2012.

### 3. Basel II and III

## Basel III proposal (expected capital and liquidity shortfalls)



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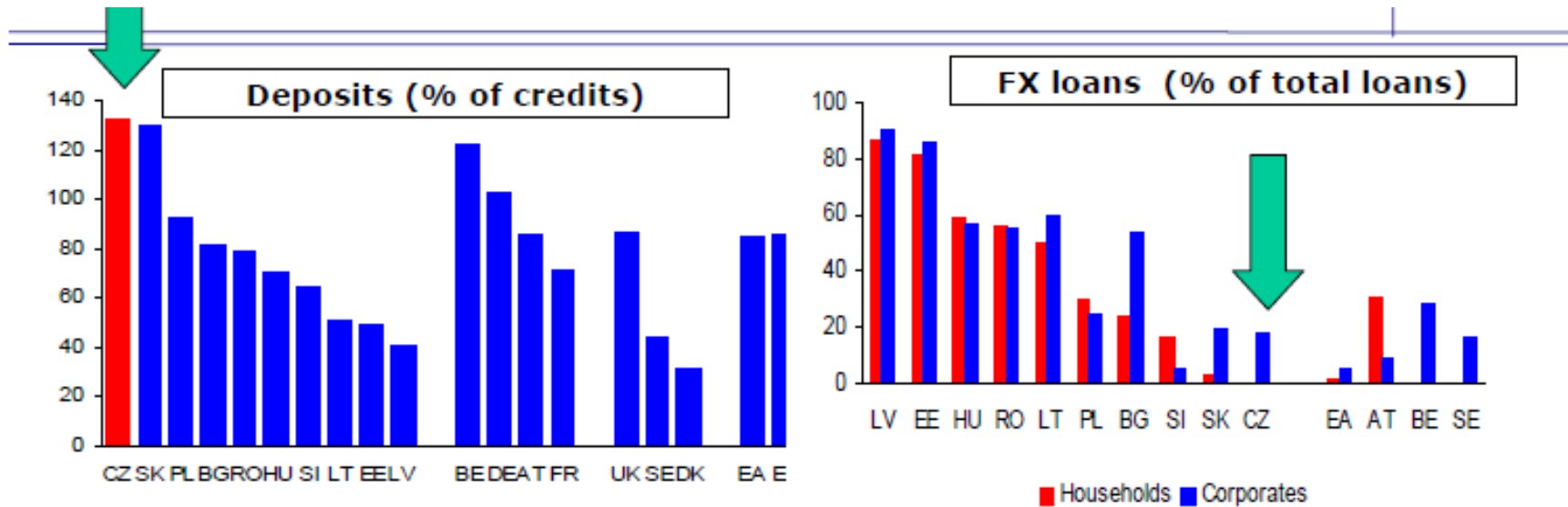
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## 4. Basel III in the Czech banking sector



# High capital ratios and liquidity buffers -> strong position!?



- Deposits exceed loans by 30%, highest value in EU
- Very low share of FX loans in corporate sector (18%), almost no FX loans drawn by households
- No liquidity domestic/international support for Czech banks needed
- Case by case gap mismatch (LT loans vs. ST, MT deposits)

Source: CNB (2009)

## 4. Basel III in the Czech banking sector

### Direct and indirect impacts on Czech banks

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#### Direct effects

- Higher liquidity requirements
- Higher capital requirements for counterparty risk
- Higher capital requirements for trade finance products

#### Indirect effects

- Lower banks' profitability due to expected lower growth of the Czech economy
- Uncertain reaction on regulatory proposals of foreign parent banks





- 1) Lower banks' profitability due to expected lower growth of the Czech economy (resulted from Basel III implementation in Western Europe) and
- 2) Uncertain reaction on regulatory proposals of foreign parent banks that own a vast majority of banks in the Czech Republic. Different impact on bank capital of branches vs. subsidiaries. Jurisdictions ?<sub>Eg.</sub>

The minimum limit for capital conservation buffer is 2.5% of Tier 1 capital. This percentage cannot however be counted into regulatory minimum capital. Banks first have to keep 6% of Tier 1 and 8% of total capital adequacy and only then can use the excessive capital to build the conservation buffer. And countercyclical buffer ?

## 4. Basel III in the Czech banking sector

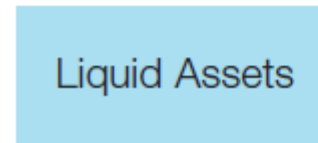
### 1. Direct impact - higher liquidity requirements (1/2)

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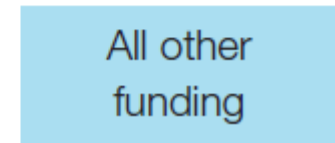
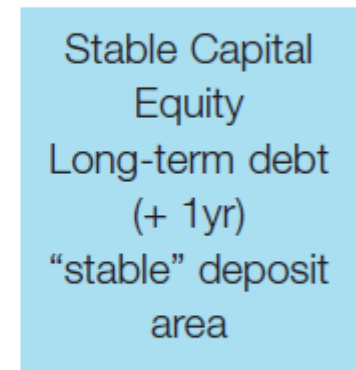
- The Net Stable Funding Ratio (NSFR) requires a bank to fund the illiquid portion of its asset book with funding of more than one year residual maturity
- Stable funding is required to finance illiquid assets (not liquidated within 12 months)
- The observation period 2012-2017 and in force from 2018?!
- Recalibration?

#### NSFR in a Nutshell

##### Assets



##### Liabilities



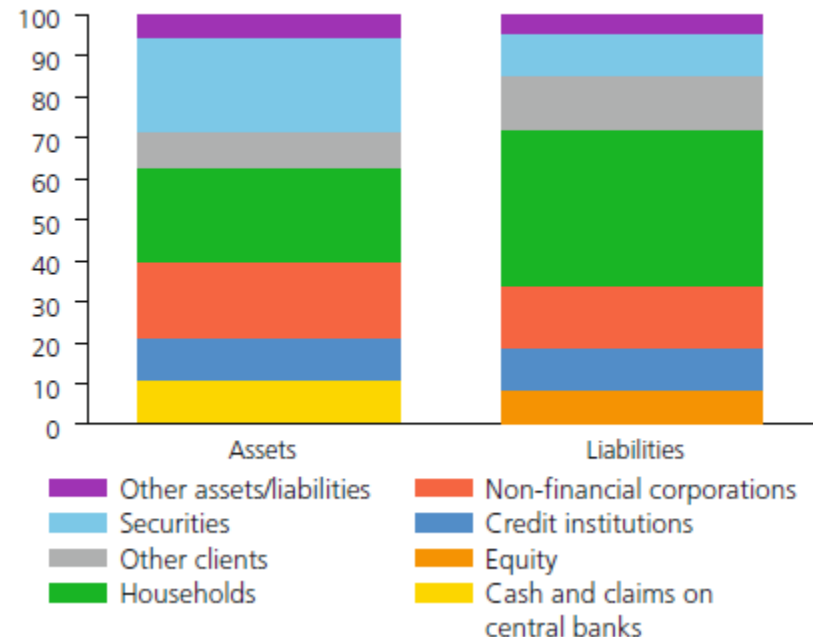


## 4. Basel III in the Czech banking sector

### 1. Direct impact - higher liquidity requirements (2/2)

- Strong liquidity position but **unfavourable financing structure**: (high share of demand deposits vs long-term loans)
- O/N deposits represented 31% of liabilities in the CR vs 11% in the EMU)
- But a share over 2Y bonds 6% in the CR vs 13% in the EMU)
- Impact of calibration?

Structure of banking sector assets and liabilities  
(% of total assets/liabilities; 2009)





### 2. Direct impact - Higher capital requirements for counterparty risk (1/2)

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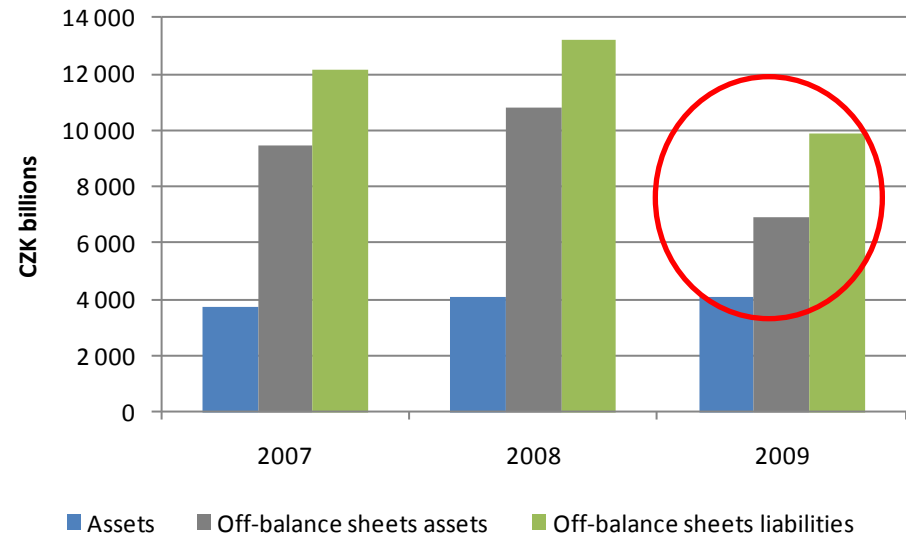
- Risk Weightings - derivative and securities financing exposures (counterparty risk materialized during the crisis e.g CDS)
  - 1) Requirement on counterparty risk modelling (both default and deterioration in counterparty's credit)
  - 2) Requirement on identification of legal connection between an exposure and related credit risk hedging instruments ("specific wrongway risk").
  - 3) Requirement on higher risk weights for OTC market transactions
  - 4) Requirement on a small risk charge (1-3%) in respect of position and collateral exposures to central counterparties (CCPs).



## 4. Basel III in the Czech banking sector

### 2. Direct impact - Higher capital requirements for counterparty risk (2/2)

- The CR = an open economy with high levels of hedging -> High engagement of Czech banks on OTC markets
- 80% of OBS assets of Czech banks are receivables from futures, forwards, swaps etc.
- Possible higher capital requirements
- Calibration?
- Possible reduction of liquidity of this OTC market and higher transaction costs (and risk).



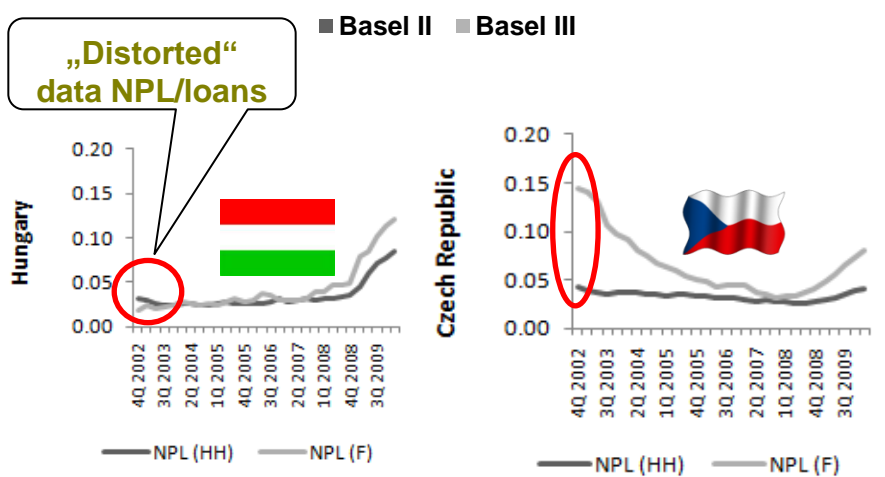
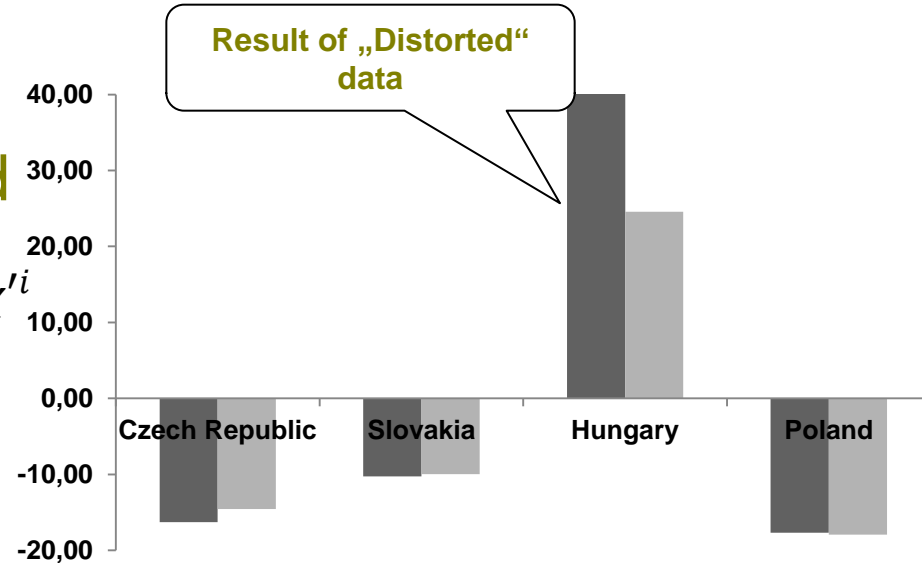
# 4. Basel III in the Czech banking sector

## Procyclicality under Basel II and Basel III in CEE

- Positive effect on procyclicality of Basel III in CZE and SLK (for corporates)/approximated through NPLs
- Figure: Lower abs value of the parameter  $\chi^i$ , lower procyclicality

$$w_t^i = (1 - \rho^i)\chi^i(\log Y_t - \log Y_{t-4}) + \rho^i w_{t-1}^i \quad i = HH, F$$

- Hungary: distorted data on 5-year horizon on "low" NPLs (high NPL offset by stronger HUF) -> distorted results based on Basel III formula – lesson for regulators!



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## 5. Basel III and trade finance

### Trade finance basics (1/2)

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- Trade finance = short-term cost-effective sources of financing (to fill the time-lag between the production of goods and receipt of payments)
- Trade finance products = a off-balance sheet item for banks
- The bank-intermediated trade finance underpins around 30% of world trade
- Trade finance facilities provided by banks to importers and exporters can include:
  - commitments such as opening letters-of-credit (“LCs”); accepting and confirming LCs; and issuing performance guarantees, bid bonds and standby letters of credit;
  - financing such as negotiation and discounting of export bills, pre-export financing, post-export financing and import financing.

## 5. Basel III and trade finance

### Trade finance basics (2/2)

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- Trade finance has historically maintained a **low risk profile** in comparison with other financial instruments.
  - the fixed, short-term maturity of trade finance products,
  - exposures are liquidated by cash upon maturity.
  - the transactional nature of trade financing allows banks to carefully manage exposures.
- The International Chamber of Commerce (ICC) together with the Asian Development Bank, created a register of **5.22 million trade finance transactions** conducted around the world by nine international banks over the past five years.
- Empirical data to present to regulators on the average duration (115 days) of a trade finance deal and on total **0.02% default rate!!!** (=just 1,140 defaults)

## 5. Basel III and trade finance

### 3. Direct impact - Higher CR for trade finance products (1/2)

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- Idea of Basel III:
    - a) all OBS items are a significant source of leverage within the financial system; and
    - b) the failure to include OBS items in the measure of exposure creates an “incentive to shift items off the balance sheet to avoid the leverage ratio constraint”.
  - Basel III: a credit conversion factor of 100% is assumed ->, banks would be required to hold capital against **the entire value of a trade finance lending commitment** (up from 20% under Basel II and of 10% from Basel I).
  - Impact of Basel III on trade finance (Standard Chartered):
    - a **\$270bn (1.8%) reduction in international trade flows** and **0.5% reduction in GDP**
    - to a 6% reduction in global trade finance capacity, as well as **an increase in pricing of as much as 40%**.
-

## 5. Basel III and trade finance

### 3. Direct impact - Higher CR for trade finance products (2/2)

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- Under Basel II framework, the most frequently used Credit Conversion Factors (“CCF”) for off-balance sheet trade products are:
  - 20% for “**trade-related contingencies**”—i.e. contingent liabilities that arise from trade-related obligations underpinned by the movement of goods or the provision of services (e.g. **letter of credits**); and
  - 50% for “**transaction related contingencies**”—guarantees that support certain performance obligations of a borrower, the calling of which are contingent on the overall performance (rather than financial position) of the borrower (e.g. **performance guarantees**).

## 5. Basel III and trade finance

# ICC's recommendations on Basel III and trade finance

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### ➤ 3 recommendations from ICC for G20

#### 1) Leverage

- ✓ Increasing the CCF to 100% for trade-related contingencies -> significantly disadvantage trade finance-focused banks
- ✓ ICC: Apply a lower (positive) CCF for unconditionally cancellable commitments or Basel II standardized CCFs + industry benchmarking

#### 2) **Capital and maturity floor** (Basel II: a 1-year maturity floor, but TF 0-180 days -> ICC: waive the floor – see national discretion in Germany, Hong Kong or the UK]

#### 3) **Liquidity** (ICC: to include trade instruments below 30 days and correspondent banking deposits as a stable source of funding)

- 3 key recommendations from EBF
  - 1) To fully evaluate the effects of the Leverage Ratio on the availability of trade and **export finance**;
  - 2) To recognize the normal liquidity profile of **export credits** (cash inflows/repayments and undrawn portion);
  - 3) To achieve a real global level playing field in the implementation of Basel III, in particular by harmonizing provisions that allow **export credits to be eligible at the refinancing windows of Central Banks.**

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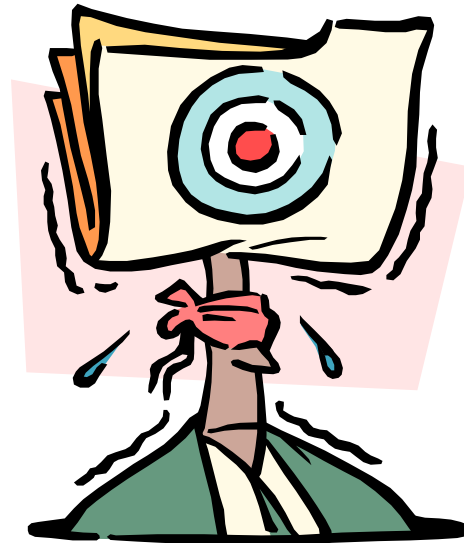
## 5. Conclusion

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- Basel III seems to have improvements but will it be sufficient?
- Strong position of the Czech banking sector -> not significant impacts of Basel III assumed
- Direct effects and indirect effects
- Impact on trade finance and export financing
- ICC recommendations
  1. Leverage (lower CCFs for OBS trade products)
  2. Capital and maturity floor (waive the floor)
  3. Liquidity (stable funding)

Thanks for your attention.

Lets discuss it now!

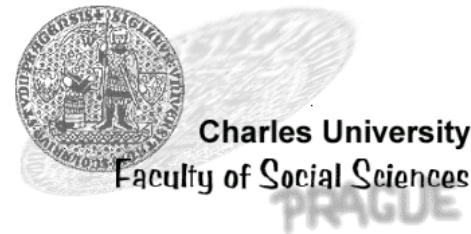


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