



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Basel 2-3

(Part one) These terms are often mentioned in the media and actually refer to most relevant elements for the financial sector in general and the area we consider more closely, that is investment arenas and portfolio management. Under the label Basel 2 (of which Basel 3 may be seen as a next evolution and updating phase) lie a set of international agreements, signed in the Swiss city, and concerning banking operations, related risk evaluations, and particularly the capital requirements banks need in order to avoid, or at least better manage, those risks when they arise. The practical goal was to design ratios between risks taken (as defined according to fixed and standardized criteria) and the relative minimal capitalization requirements. Actually the agreements also consider other features besides the risk-capital ratios, as the roles and powers of supervising agencies, both domestic and supranational, the market regulations and the measures aimed at increasing its transparency. The rules of Basel 2 were adopted in January 2007, just before the prelude of the dramatic storm which was to disrupt the financial markets and the banking sectors of many countries, particularly the Western ones: having then shown all their limits and inadequacy, wide changes and integrations have become necessary, so taking to the new Basel 3 issues. The reasons at the root of the previous Basel 2 agreements were mainly to be found in the not so prudent and efficient procedures many banks adopted in assessing their credit positions and their borrowers' reliability. The increasing market complexity and the appearance of new actors, as well as new financial vehicles (e.g. hedge funds, private equity, derivatives, products of different sorts of securitizations, larger use of non-bank credit, new forms of borrowing,...) had in the meantime made the scenario more complex and undefined, also in relation to risk evaluations, as following events were dramatically to show. *(to be continued)- GLT*

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(Part Two) The major aim of the agreements was the stabilization of the banking sector, better balancing its capitalizations and debt exposures, to be assessed through more standardized and efficient methods than the ones previously employed. That was happening during a phase, then rocked by the dramatic events of the past years, which was marked by greater and greater runs to borrowing and more and more diffused leverage levels. Moreover, although the agreements also claimed goals of increased operational transparency, together with more protection and guarantees for savers and investors, we may now say that neither such objectives have been reached by Basel 2. For the best and the worst and despite many limitations, Basel 2 however was an improvement if compared with the previous criteria – Basel 1 – according to which the corporate financial capability and reliability were just evaluated according to the company's seniority, its assets and market positioning, with no attention for financial ratios and other indicators now used in assessing the ability to repay debts in due times and ways. The most important quantitative datum Basel 2 set was the 8% of solvency ratio: it measures, or better measured until now, due to the radical changes that Basel 3 is expected to show, the minimal level of capitalizations required for banks in relation to their volumes of activities, weighted according to the credit risks they involve. Such levels were set according to historical-statistical methods, particularly the VAR approach that we have discussed some time ago and, in the view of their promoters, they had to cover the three types of risks which banks face: the credit risks in strict sense (that is insolvency of companies and institutions to which they lend money), market risks (e.g. losses on securities and instruments they hold in their portfolios); operational risks, linked to the many operations they carry on also outside the credit area, and which may be related to internal or external frauds, refunds for responsibility towards clients or staff, irregular transactions and money recycling, acts of terrorism, natural or criminal damages, computer malfunctions or cyber-attacks,...The last typology, which was called "operational", had not been considered in the Basel 1 protocols, and marked an actual improvement, also because their incidence was to prove all but negligible for the financial and general destinies of many banks in the next years. *(to be continued)*-
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(Part Three) The capital levels that Basel 2 required were aimed at standing up to three types of banking risk: credit risk in typical terms, market risks (that is the ones related to counterparts and values of financial assets they hold) and operational risks, these ones having not been previously considered in Basel 1 protocols, and linked to different causes, such as frauds and incidents, compensations and material damages, informational malfunctions and attacks,...The minimal capital requirement was calculated by multiplying the base coefficient of 15% for the bank's gross income (as the average of the latest 3 years). Adaptations were provided for specific functions which were particularly relevant, such as corporate finance, trading, retail banking, commercial banking, fiduciary operations and asset management... A critical point in assessing credit risk is to define ratings, that is the financial capabilities and reliabilities of clients, being they private persons, companies, firms or any other institutions. Risk level, solvency, market position, productivity and ability to generate income in the future are very sensitive points to be assessed when lending, so to define what is today often measured through CDS's, the indicators of a debtor's probability to default or, in positive terms, its solvency ratio. As we have already noted, Basel 2 set important improvements if compared with the tools previously employed, and an integration between external and internal methods was adopted. Thus, besides the ratings issued by specializing agencies – by the way no longer regarded as much significant, or at least timely - other ratings were to be assumed which came from internal risk management models. Of course they were to be transparent and homogeneous, automatic in their functioning and highly standardized in collecting data, treating them and stating the different risk classes. All was then supervised by external and independent institutions, which monitored those procedures for three years before ratifying them. *(to be continued)- GLT*

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(Part Four) The rating tool that Basel 2 activated, in order to better assess the financial status and reliability of banks' clients, that is the risk level related to loans granted to them, is a sensitive one, in terms of standardization needs and procedural effectiveness, the latter being submitted to a three years trial period, not to mention the question of the reliability of the evaluating institutions themselves. Indeed in the latest years the leading world agencies in the field have been widely criticized for their lack of transparency, timing, and even conflicts of interest in carrying on their analysis and issuing the related judgements. Basel 2 fixed some guidelines in this area, but mainly from the bank's standpoint, according to which, for example, it was excluded to choose for any debtor the rating agency which had issued the most favourable assessment, in order to lower the general risk level. As for the weighting of the risk credits, still the most important in the Basel 2 perspective, three methods were considered: the "standardized" one, the "basic" IRB and the "advanced" IRB. The first procedure is a derivation of Basel 1, in that it considers an average reserve ratio of 8% of the bank's exposures, to be weighted according to the debtors' risk levels and the types of loans granted. However such reserve level is flexible itself, and may be adjusted according to the debtor's rating. Thus in case of a top rating (AAA), the 8% ratio may be reduced, thanks to the supposed counterpart's high reliability and the related lower default risk. In case of a low rating the ratio would be proportionally increased. However such criteria proved some inadequate, being mostly based on a firm's structural and dimensional features, rather than on more relevant functional and financial parameters. Moreover banks seem to act in passive and not so much responsible ways under such rules. The IRB method was actually adopted in order to avert those limitations, through the introduction of quantitative rations more in line with the market reality, so to gauge what today's CDS's define as default probability of a given debtor. But then the concept of default itself needed to be clearly defined. *(to be continued)- GLT*

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(Part Five) The risk weighting methods that Basel 2 adopted, besides introducing new assessment criteria and ratings by banks themselves and specializing external institutions according to standardized and consolidated rules, also better defined the concept of default. Whilst bank lending operated internationally, defining default was pretty a matter of different national interpretations, so that a common definition was needed. According to Basel 2 a debtor defaults should one of these conditions takes place, being however the first one subjective and undefined: the lending bank comes to consider the debtor unlikely to meet its obligations, according to not specified criteria. The second one, more objectively considers a delay in due payments of 90 days at least. For some countries, including Italy, the time of delay was extended to 180 days. Such definition of default is somehow full of gaps and well far away from the one commonly adopted by the financial markets and founded on the Anglo-Saxon tradition: a default takes place whenever a debtor misses a payment, both of principal and interests, at due expiration, without any delay time allowed. Moreover, switching an expiring instrument into another (restructuring) in order to avoid a payment in cash, is a case of full default itself. However softer criteria were adopted by Basel 2 with the so called IRB method. But the agreements also considered a more sophisticated, and more expensive, approach, which was defined IRB "advanced", according to which more parameters were defined, in particular the LGD (loss given default) and the EAD (exposure at default). The first one is the loss arising in case of default, that is the percent of debt which is lost. The EAD is the residual debt amount at the time of default, that is the relation between the amount which has been already paid back and the one which is still to be returned. These methods may be interesting and innovative for the banking sector which was previously pretty *naïf* in assessing its lending risks. However even more important is to adopt strict procedures and objective parameters really in line with actual market conditions. *(to be continued)*-
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(Part Six) Among the types of risks that Basel 2 agreements had considered in defining the minimal capitalization level for banks, if the generally defined “operational” and the credit ones were to prove relevant, the third type of them hit even harder, and sometimes in devastating ways, the balance sheets of many financial institutions. The third section actually was the one related to “market risks”, thus including losses incurred in negotiating (or being precluded to negotiate) financial instruments the banks held, foreign exchange and rate risks, as well as counterparty risks, had a transaction not to be duly settled because of a state of insolvency or operational block of the other involved dealing party. Obviously the recent financial history has deeply affected all those areas of risk: if the exchange risks may be easily, although sometimes costly, hedged through forward contracts and derivatives, as well as the rate risks, at least partially, other market losses and counterparty “incidents” are pretty harder to adequately evaluate and contrast, all the more during the stormy and panic-dominated market phases. The latter were so diffused during the “big crash” to have taken several banks to bankruptcy or on the verge of it, so to require huge and urgent recapitalizations in order to allow them to survive. All in all such risk categories are normally assessed and managed by risk management teams which employ specific models and report directly to the banks’ boards. The risk evaluation methods they adopt are widely based on the VaR-*Value-at-Risk* pattern – that we have formerly discussed: it is a set of statistical tools which according to historical series of values, define the probability with which certain levels of losses may occur. But, as for any statistical models, they are valid in relative ways, in that they assume that what happened historically is likely to repeat itself in the future, that markets move according to Gaussian probability patterns, and that unlikely and unpredictable events, all the same causing disruptive outcomes, do not take place, even repeatedly, thus fooling any probabilistic dogmas, as Nassim Nicholas Taleb has smartly discussed in his works devoted to the “black swans” and their influences. *(to be continued)- GLT*

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(Part Seven) The principles and methods introduced by Basel 2 agreements surely marked an improvement in comparison with previous procedures banks and other financial institutions used in assessing and managing their different types of risks, namely operational, credit and market ones. Moreover they allowed better evaluations of the new corporate activities with different financing needs and earnings flows from traditional ones. However we noted that the statistical foundations on which many of such methods are based, e.g. the VaR-Value-at-Risk model, may prove ineffective or insufficient at least. Those procedures may also be expensive and out of reach for smaller and less structured institutions, so to distort competition, and many managers and entrepreneurs also consider them some too intrusive. Anyway stronger rules and more rigid and sophisticated methodologies did not succeed in avoiding big problems in the recent past: so Basel 2 was to prove inadequate in a scenario dominated by excessive debt and high leverages which were to took to the most dramatic crisis in the financial markets and the real economies. In the end many Basel 2 rules simply went "blown" and during and after the storm the needs of recapitalization have looked dramatically huge, so to need massive public interventions, in the US and Europe, and even in Switzerland. Thus a new goal besides a balance between capitalizations and debt exposures has prevailed, that is the stabilization of the financial system as a whole. Such new proposals would be aimed at avoiding situations as the ones in the after-Lehman phase, when the inter-bank lending system was actually blocked due to worries of reciprocal defaults in any market corners. The unsuccessful attempt of Basel 2 and one of the basis of Basel 3 is then a new market discipline, with interventions on corporate governance and capitalization structures which profit from recent past events. *(to be continued)- GLT*

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(Part Eight) The implementation of principles, methods and procedures of Basel 2 agreements have been conditioned by different national environments, banking traditions and concepts of capitalizations themselves. Even more difficult has been the merging of such rules into the various national legislations and operational practices, also due to the weight of the public sectors in the banking systems of many countries, not to say of the dramatic events which have affected the markets during the years that followed the implementations and reached their climax in 2008 and 2009. That said, the third main goal of Basel 2, that is a general market stabilization well beyond the sole balance between capitalization and risk exposure, could not be reached, due to both the structural limits of the agreements themselves and the exceptional and dramatic conditions with which banking and financial areas were confronted. However the standardization process has gone on in many geographical areas, such as the United States, the European Union, Switzerland and, among the emerging markets, firstly in India.

And while Basel 2 was being implemented, as currently is still the case in many countries, a newly revised version of the agreements was promoted by several institutions as a need after the disruptive storms, and a major voice calling for that was the BIS-Bank for International Settlements. If Basel 2 was particularly important for its internal consequences in the banking industry, in terms of assessment and management tools, Basel 3 also is to affect the financial markets even more broadly and the area of investments as well.

Indeed Basel 3 is not just expected to introduce credit limits against operational counterparts in transactions, to set anti-cyclical buffers, so adjusting requirements to economic scenarios, to fix minimal liquidity standards, but also to set leverage levels more strictly and first of all redefine the concepts of "high quality" common equity for banks and financial institutions, that is share capital plus reserves, which has to stay at 4.5% within January 2015 and then increase up to 7% afterwards. *(to be continued) - GLT*

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(Part Nine) The changes that Basel 3 proposes are also the result of what has happened during the financial turmoil and aim at making the banking and financial systems in general more resilient against future internal and external shocks, wherever they come from, and possibly avoiding that financial problems spread into the economic environment. The main points still are capitalization and liquidity. The first one is more carefully considered, both in terms of its quality, that is composition, and implementation path, although, due to the difficult current scenario, such implementation may not be immediate but diluted over time. A great importance is attributed to the Tier 1 – the first level of capital composition, that we will discuss next. In the new proposals it must be mainly made up of common shares and retained earnings. Also the second level of capitalization, Tier 2, is better defined by Basel 3 and standardized at international levels. As a consequence of recent dramatic events, the needs of capitalization are related to the risks of counterparts with which the bank works and the special situations that may arise during market transactions. That is the case for bank derivatives exposures, repo trades (selling securities with commitment to repurchase them) and other transactions on those instruments that may have high price volatility and liquidity problems. Buffers for such operations are increased and Basel 3 incentives the switching of derivative contracts from OTC tradings, that is executed outside institutional markets to more reliable counterparts, such as major clearing houses. Meanwhile the setting of effective risk management structures is urged, not only devoted to “in house” assessments, but also for the analyses of operational counterparts for the institution itself. Basel 3 also sets more strict leverage ratios and, for the first time, considers the creation of capitalization buffers in the favourable years so to be used during more problematic periods, in order to better absorb shocks and decrease the risk correlation throughout the economic cycles. *(to be continued) - GLT*

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(Part Ten) Among the major guidelines of Basel 3 agreements we have considered increased transparency and more strict risk assessments, also extended to the counterparts of banking institutions in their market transactions, the creation of buffers aimed at making risks less correlated with economic cycles and possible phases of credit bubbles. Moreover banks are requested to implement systematic stress tests for scenarios marked by widening spreads, that is the yields market operators request in relation to the reliability and financial conditions of different subjects, also for the cases of recessive environments. Such stress tests are expected to be more significant than the "diluted" ones carried on recently by European banks according to the ECB directions. But Basel 3 not only rules about capitalization and risk evaluation criteria, but also tackles another important topic, particularly sensitive and critical during the past crisis, that is liquidity: a minimal liquidity standard is then required, at least for banks operating at international levels, amounting to a minimal cash flow for 30 operational days, apart from other liquidity ratios on longer terms basis.

Before reviewing more specific features of Basel 3 agreements, as the already cited Tier 1 concept of capitalization and its consequences in the creation of new financial instruments, we may wonder which impacts the implementation of the agreements may have on the general economic environments. Other factors being equal, more strict credit controls and more balanced levels of loans and capitalizations may cause GDP contractions, not only due to more selectivity in granting loans, but also due to the higher costs that Basel 3 procedures and instruments involve for banks, all the more when operational margins are getting narrower. In order to comply with the ratios set for 2015 (4.5% common equity, 6% Tier 1) and 2019 (7% common equity, 8.5% Tier 1), banks will be forced to increase credit spreads, in likely hugely terms. Of course it will also depend from the evolution of overall economic and financial scenarios, inflative pressures and related policies by central banks. *(to be continued) - GLT*

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