Financial regulation and supervision finance essay

Finance

Hu YuContentsExecutive summaryThis report is suitable to RBS for investor consultancy of UK market. This report is based on Basel III. This report is about the Basel III. The references are from: website. The main issues are: time limited, Basel III is new and just started hard to find relevant data. The report is made by RBS. 1. The main drivers for the creation of Basel IIIIn 2007, the Subprime lending Crisis was happened in the USA, and finally became a worldwide Financial Crisis, the influence continued till now. A lot of bank broke during this time, large banks like Lehman Brother could not escape, the benefit of the depositors was been hurt strongly. During this crisis a lot of issues in Basel ii had been found: The overall quality of Capital of global banks' is poor while the Financial Crisis was happening. There was not a consistent regulation for the leverage for the recent regulation system. Sufficient attention has not been paid for Procyclicality in the financial system. Strengthen risk management for individual financial institutions, and lack of systemic risk considerations. In order to strengthen risk management and regulation for bank industry, the Basel association present the Basel iii, the Basel iii is aim to enhance the ability of defence financial shock and economic fluctuation, enhance risk management and management level, and enhance the diaphaneity and Levels of disclosure. The main reasons for the creation of Basel iii are: Avoid the moral hazard of ' too large to fail'. To reduce the social cost of the failure of a financial institution, as a result that may not cause a wider damage. To protect the financial system stability. To protect the real economic. Those reasons drove the Basel Committee to change the unsuccessful Basel Accord, to make the market going better and safer. 2. Differences between Basel II and IIIBasel iii reflects the newest idea of global banking industry regulation. Basel II is based on the Asia financial

Crisis in 1997, it is aim: To amend the old Basel Accord(Basel I). To standardize the risk management system. To improve the risk management ability of International financial Services. The core idea for Basel II is three pillars: Minimum Capital Requirement: the minimum capital adequacy ratio no less than 8%, the core capital adequacy ratio of the bank's should be no less than 4%. That could make the bank more sensitive for risk, and more effective for operation. Supervision and inspection from Regulatory departments: the regulator can decide if the bank could be operated successfully by monitor, and can give some improvement project. Market Discipline: Bank should announce their capital structure, Risk Exposure, the internal evaluation mechanism of assets to charge and the strategy of risk management for the bank. Basel III is based on the Subprime Crisis in 2007 while the Basel II was just announced. After the experience of the crisis, Basel III focuses on safety more than efficient, it represents the new idea of Financial Services: Micro supervision and Marco prudential combined. Capital regulation and liquidity regulation both emphasized. Pay attention to both number and quality. Set up a new standard for bank supervision. Due to the Crisis in 2007, the world economic is now walking in a swamp, slow and hard, lots of countries still can not move or even sink now, the crisis made managers know that there are a lot of fault in Basel II: Systematic risk in Asset securitization trade. VAR could not fully show the risk of trade. Capital requirements and risk management of counterparty's credit. Off-balance sheet risks reflect is insufficient. Transparency of complex-structure products trading. The main change of Basel III: Capital: No less of 7 per cent of banks' Risk Weighted Assets which was 2% in Basel II must be used as a buffer to against losses. The liabilities of core tier one will be narrowed by definition.

Leverage rate will be introduced to the global financial regulation system. Risk Weighted Assets: Improve both quality and quantity of capital, updates the calculation tools for the counterparty credit risk. The financial institution asset value correlation (FI AVC) will be amended to increase the Risk Weighted Assets for banks’ exposures to large and/ or unregulated financial institutions. Liquidity: The Liquidity Coverage Ratio (LCR) defines the amount of unencumbered, low risk assets (such as cash or gilts) that banks must hold to offset forecast cash outflows during a 30-day crisis. Outflows are estimated, based on the nature of the customer relationship and the type of product Leverage. A new leverage ratio of 3 per cent is due to become mandatory in 2018. This seeks to ensure banks apply adequate capital to all their exposures, including those off balance sheets, and without applying any risk weightings. 3. Implications of implementing Basel III liquidity requirementsThe global crisis in 2007 had shown the disadvantages for Basel II, people were distrusting the efficacy of financial regulatory. In 2009 G20 London stated to build a consistent high standard capital regulation and liquidity supervision framework. Liquidity was definition by 3 stages: financial instruments liquidity, market liquidity and currency liquidity. Reasons for liquidity regulation：To avoid coordination failure, coordination failure is the primary cause of liquidity shortage. To reduce the uncertainly of bank strategy. In Basel III, the Basel committee had introduced 4 monitoring tools for liquidity regulation. These tools could help the regulator to monitor the liquidity. The importance of liquidity regulation of Basel III: High quality capital could help bank to face the liquidity risk while bank is under pressure. Centralize counterparty trade has controlled the contagion effect of liquidity risk for counterparty trade risk. Attach great importance to the systemically

important financial institution (SIFI) could limit the destructive effect of systematic liquidity. Standard & Poor's Corp stated: Basel III will increase the cost of bank loan, and the cost will be surely passed to the enterprises. Basel III set up a much higher rate of buffer against losses; the banks' Risk Weighted Assets have increased at least 5% from Basel II to Basel III. Presume the international capital flow as a fixed number, before Basel III 98% of the capital could be used, but for Basel III only (98%-7%+2%-2. 5%) = 90. 5% could be used for loan. As the same number of capital size, the available capital has decreased at least 7. 5%, while the number is larger the Risk Weighted Asset is larger, because of the characteristics of bank industry, the asset-liability ratio are higher than any other industries, actually 92% was said as a safe rate of ratio for bank, which means 92% of banks' asset is from loan, in another word, 92% of banks' assets are from depositor. Money from depositor are not free, the increasing 7. 5% of total asset for the bank could not get any income for the bank, and the total unavailable asset is 9. 5% nearly 10% of the total asset of bank could not been used to gain profits. To presume the average Account interest is 1%, the whole asset of the bank is £ 100: Bank asset: £ 100 available asset for loan□£ 90. 5□ interest□1% * 92% * 100 = £ 0. 92□ presume the available asset has all been borrowed: the lowest interest should be £ 0. 92/ £ 90. 5, compare with Basel II: the available asset is £ 98: £ 0. 92/ £ 98. The cost is higher than Basel II. Liquidity requirements: (Ernst & Young, 2013)The LCR, which is designed to establish a minimum level of high-quality liquid resources sufficient to meet an acute stress lasting for 30 calendar days. The NSFR, which is designed to influence the structure of funding by creating incentives for banks to fund assets that are not readily saleable with stable

funding. Due to the dissenting opinion of Basel III, it was announce to be carried out in a timeline which was extended to 2018 and should be settled by the local regulator by a suitable rate. The Basel committee had already settled up a supervision system for collect and monitor. FSA Financial Services Authority has already started mismatch report with a single resource of underlying data used for internal risk management and regulatory report. Report from KPMG states: the new global liquidity rule will bring a bigger challenge for the banks, the mean challenges are: the increasing cost and decreasing profit. It may be a disaster for the small banks to reduce their cost, and due to the new implementation method of Basel III (decided by the central bank), the overseas business for International banks such as HSBC Barclays will be more complex than before. Some people are worried about the time of Basel III was introduced, they said the stricter regulation of Basel III will not benefit for the slumping world economic, even could made the economic growth not steady. Whereas the regulator will also focus on the accident which was brought by the innovation of regulator, and the Basel III will be implement by step could reduce the accidents. Because of the innovation of liquidity, the loss of the risk could be limited to a better rate. But for bank, that is a challenge, bank should to build an immediately daily liquidity regulation system to reduce the risk of liquidity, enhance deposits and loans, improve structure of investments, build up a system which based on the interest change to monitor the deposits and loans, know precisely of the cash flow for the banking outlets. The asset and liability should be precision pricingto make liquidity management refine. The liquidity requirement of Basel III will slow down the nominal economic growth for, which is owing to the conservative

liquidity policy, but for a long term, this will reduce the risk of crisis and increase the real long term economic growth rate. 4. Use of literature and evidence of wider readingBa S S (2012), The influence of Basel III in Chinese banking industry. http://www. cnki. net/Deloitte (2012), Unscramble of Basel III, http://www. deloitte. comRBS (2013), Basel III: Need to know, www. rbs. co. uk/Ernst & Young, (2013), Basel III liquidity requirements and implications Implementing the framework, http://www. ey. com/JP Morgan (2013), Liquidity Regulation in the UK & Europe Impact on International Banks and Broker-Dealers www. jpmorgan. comICBC, (2013), The Impaction of Basel III for Europe is stronger than USA, WWW. ICBC. COMChina Banking Regulatory Commission (2013), Basel III: Content and Influence, www. cbrc. gov. cn/Goldman Sachs (2013) Basel III Impact Report, http://www. goldmansachs. com