

## Basel III and its Potential Implications on Malaysia and the Financial System

### Basel III and the global financial reforms

In September 2010, the Basel Committee on Banking Supervision (BCBS) endorsed a package of reforms to strengthen global capital standards and introduce global standards for liquidity – now collectively referred to as Basel III. The reforms which represent the core components of the global financial reform agenda aim to improve the banking sector’s ability to absorb financial and economic shocks, thus reducing the risk of spillover from the financial sector to the real economy. This article discusses the implementation of the Basel III capital and liquidity reforms for banking institutions in Malaysia.

**Table 1**

#### Elements of the Basel III reform package

Areas	Reform measures
Capital	<ul style="list-style-type: none"> <li>• Raise the quality, consistency and transparency of the capital base so that banks are better able to absorb losses on both a going concern and a gone concern basis.</li> <li>• Strengthen capital requirements for counterparty credit risk exposures arising from derivatives and securities financing activities.</li> <li>• Raise the level of minimum capital requirements, particularly for Tier-1 capital and common equity.</li> <li>• Incentivise the conservation of capital through the build-up of capital buffers above the minimum requirement which can be drawn down by individual banks as losses are incurred.</li> <li>• Promote the build-up of counter-cyclical capital buffers at the system level to protect the banking sector from periods of excessive credit growth and thus maintain the flow of credit in the economy during a downturn.</li> <li>• Introduce a non-risk-based leverage ratio to reinforce risk-based requirements and constrain the build-up of leverage, thus mitigating the effects of excessive deleveraging in the banking system during distressed periods.</li> </ul>
Liquidity	<ul style="list-style-type: none"> <li>• Introduce a Liquidity Coverage Ratio (LCR) to ensure that banks have sufficient high quality liquid resources to survive an acute stress scenario lasting a month.</li> <li>• Introduce a Net Stable Funding Ratio (NSFR) to promote resilience over a longer-term horizon by creating incentives for banks to fund activities with more stable sources of funding on an ongoing basis.</li> </ul>

### Implementation of Basel III in Malaysia

Banking institutions in Malaysia will be able to transition into Basel III from a position of strength owing to the extensive reform initiatives undertaken by the Bank and the industry following the Asian financial crisis. All major elements of the Basel II capital framework – including the Internal Ratings-Based approach for credit risk as well as the Pillar 2 and Pillar 3 components – have been put in place. Explicit liquidity requirements which ensure that banking institutions hold adequate high quality liquid resources to survive acute stress situations, consistent with the objectives of the LCR introduced by the BCBS, have also been in place for over a decade. With minimal exposures to complex and high-risk off-balance sheet activities which are mainly targeted by the reforms, strong starting capital positions (common equity and reserves currently contribute towards approximately 70% of the banking system’s total capital) and leverage levels in line with that permitted under Basel III (the banking system leverage is 5.9%, against the minimum 3%), the need for substantial structural adjustments in the Malaysian banking system will be less significant than those of advanced economies.

The implementation of Basel III in Malaysia will further reinforce these foundations, while reducing procyclicality and contagion within the financial system. With their greater regional presence, Malaysian financial institutions can also expect to be held up to greater scrutiny by investors, analysts and market participants in respect of their compliance to global standards. For these reasons, the Bank has already initiated work to develop strategies for Basel III implementation in Malaysia and will begin consultations with industry players in 2011 on specific enhancements to the existing capital and liquidity frameworks

required to give effect to the requirements of the global reform package. The sequencing and timelines of implementation of these enhancements will also be determined as part of this process.

While the BCBS has outlined an extended time frame until 2018 for the implementation of the new requirements to provide continued support for the global economic recovery process, the positive outlook maintained for Malaysia as well as the strong capital positions of banking institutions allow considerable flexibility for certain elements of the package to be implemented on an accelerated basis. Any decision to fast-track implementation in Malaysia will consider the need to ensure that the standards are implemented at a speed and manner that does not disproportionately impact individual components of the financial system or sectors of the economy. The Bank also aims to coordinate implementation with other countries within the region to avoid any material market distortions. However, this will be carefully weighed against the clear benefits of moving the domestic banking system to a higher degree of resilience in a timely fashion.

### **Implications on the economy and the financial intermediation process**

The main concerns expressed at the international level with Basel III have been the potential impact of the reforms on the cost and availability of financial services due to the need for banks to realign business strategies and restructure balance sheets, including through the build-up of larger liquidity buffers, and the raising of longer-term debt and high quality capital. The extended implementation time frame provided by the BCBS serves to mitigate the risk of resulting constrictions to the supply of credit particularly given the fragile pace and extent of global economic recovery. Based on a joint assessment by the Financial Stability Board and the BCBS released in 2010, given the reasonable implementation time frame, the transition to stronger capital and liquidity standards will likely only have a modest impact on global economic growth. It is estimated that if higher capital requirements are phased in, the annual growth rate in gross domestic product would be reduced by an average of only 0.04% over a period of four and a half years.

In Malaysia, banking institutions are already largely operating at capital adequacy and leverage levels consistent with the requirements and targets set under Basel III, thus the impact of the new capital standards on the real economy will likely be modest. Preliminary assessments by the Bank indicate that the current reported common equity ratio of the banking system, adjusted for Basel III requirements, would be approximately 9.5%, well above the minimum common equity ratio of 7% (including the capital conservation buffer). Internal capital management strategies by banking institutions to maintain comfortable buffers over the new regulatory minimums are also expected to be easily met through the retention of earnings, obviating the need for large-scale capital raising activity. This is supported by the prudent earnings retention practices of banking institutions in Malaysia over the last decade, with 57.5% of new capital of banking institutions attributable to increases in reserves and retained earnings.

Meeting the Basel III liquidity requirements will however be considerably more challenging. Based on self-assessments conducted by a number of banking institutions in 2010, the LCR under Basel III for most banking institutions is expected to range between 60-80% (against the required 100%). Reflecting the higher assumed sensitivity of wholesale funding to changes in interest rates and perceived credit risk, the new liquidity rules apply run-off rates on wholesale funding that are significantly higher than for retail deposits, and higher than that observed by distressed banking institutions in Malaysia during the Asian financial crisis. While this may incentivise banking institutions to source more stable retail deposit funding, the ability of the Malaysian banking sector as a whole to mobilise greater amounts of retail deposits in the short run is constrained by the dominance of other pensions and investment schemes (notably the Employees Provident Fund and Permodalan Nasional Berhad) that account for a significant share of household savings. Perversely, heightened competition for retail deposits may also result in banking institutions offering and potentially mis-selling complex and opaque structured investment products which may not be suitable for the general public. While other avenues such as the issuance of long-term senior debt exist for banking institutions to shore up their liquidity positions and to diversify their funding sources, this is likely to be more costly than raising retail deposits.

In view of the wider implications of the Basel III liquidity rules, the Bank intends to use the observation period<sup>1</sup> provided by the BCBS to perform further analyses of the implications of the standards for domestic financial markets and credit extension. This will leverage on data currently submitted to the Bank under the existing Liquidity Framework and additional data as may be required to facilitate the Bank's analyses. A key focus will be on monitoring the behaviour of wholesale funding sources. The outcome of this assessment will form the approach to the implementation of the LCR in Malaysia.

The need for banking institutions to shore up their capital and liquidity positions may however encourage the development of new classes of financial instruments in Malaysia. This includes covered bonds which qualify as liquid assets under Basel III and new forms of hybrid instruments which meet the more stringent criteria set by the BCBS, including contingent capital. While these instruments have been held out as cost-effective means for banks to meet the standards, they will require supporting legal, regulatory and institutional arrangements to be put in place to ensure that these instruments will perform as envisaged in a crisis, and gain acceptance among market participants. As an example, institutional investors will have to also evaluate the extent to which their investment objectives can continue to be met through investments in debt instruments that convert more easily to equity, and this in turn would depend on the defined triggers for conversion applied to such instruments. The Bank will continue its engagement with market participants and other relevant authorities on these developments during the observation period, with early attention given towards the prospects of developing a covered bond market which could qualify under Basel III.

### Remaining concerns

Two other areas of the reform package will require a more cautious approach to implementation. The first relates to the way in which total exposures are determined for the purpose of complying with the leverage ratio which requires banking institutions to hold the same amount of capital for a majority of on- and off-balance sheet exposures regardless of their inherent risks. The Bank shares concerns expressed by a number of countries that this could inappropriately disincentivise the provision of credit to low-risk and economically productive activities, such as trade financing. The second concerns the strong incentives created by the NSFR to avoid long-term financing which would affect the banking system's critical role in maturity transformation. Given the potential for unintended consequences which can harm the broader economy, particularly emerging and highly open economies, it is crucial that a careful appraisal be made of the likely effects of these measures during the observation period and appropriate adjustments incorporated prior to their full implementation. In this regard, the Bank welcomes the commitment by the BCBS to use the observation period to assess whether the proposed design and calibration of these measures are appropriate to achieve their intended objectives while avoiding economic dislocation.

### Conclusion

On balance, the implementation of Basel III is expected to deliver long-term benefits to the overall economy and financial system, with a much strengthened banking system operating as its core. With a more resilient banking system, the likelihood and severity of future banking crises will be reduced, as will the need for large-scale government interventions to support the economy and to stabilise the financial system during crises. Moreover, elements of the reform package that reduce procyclicality and promote counter-cyclical buffers will ensure that the banking sector has the capacity to support lending activities during economic downturns, thus reducing the amplitude of the business cycle. On issues that remain open in respect of specific components of the reform package, the observation period will be critical to allow a more complete assessment of the proposals and refinements to be made as appropriate to address any unintended consequences.

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<sup>1</sup> For the LCR, the BCBS has provided for an observation period beginning 2011 to end-2014 where national supervisors and the BCBS will monitor the impact of the standards on the financial systems and economies throughout the world prior to its full implementation in 2015.