A Newsletter from Chicago Underwiting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

Issue 70 **September 2010**

In this issue … we make a slight departure from our usual field of D&O and Professional liability insurance to look at the recently completed Basel III global banking agreement known as the Basel III Accord.

For most people who are not professional bankers, their eyes probably glaze over when they see the phrase "Basel III Accord," and with some justification. But while it is an arcane topic primarily of interest only to the global banking community, Basel III indirectly impacts everyone because of the fundamental role of banking in the world's economies.

THE BASEL III ACCORD: WHAT IS IT?

Basel III is an agreement reached by the Basel Committee on Banking Supervision. This committee, which is overseen by the G-10 Group of Governors and Heads of Supervision [GHOS], seeks to "promote and strengthen [banking] supervisory practices and risk management practices globally." There are 27 nation members of the committee, comprising the world's leading economies; the secretariat for the committee is in Basel, Switzerland.

Basel III follows on from the Basel II and Basel I Accords, and is concerned with the issue of capital adequacy: how much capital a bank must prudently maintain in order to support the bank's activities and exposures. Basel III stipulates what the committee has determined are the minimum capital requirements.

While the language of the agreement is replete with banking jargon, the basic message is fairly clear. The agreement mandates an increase in the applicable capital to be held by a bank in relation to its "risk-weighted assets." A risk-weighted asset is an asset that has been assigned a weighting according to its riskiness: At one end of the risk spectrum there might be gold bullion, which is typically assigned what amounts to a risk-free weighting of zero, while towards the other end could be certain investments whose ultimate value might be in some doubt.

Put simply, the riskier a bank's exposure from its assets, the more capital it must accumulate in order to provide a cushion against the possibility of those assets' values diminishing or disappearing. Insurance industry professionals will quickly spot the similarity with the Risk-Based Capital methodology used by the National Association of Insurance Commissioners to help evaluate the relative financial strengths of U.S. insurers. That formula, with its subsequent conversion to a percentage value, remains one of the better objective indicators of an insurer's capital adequacy. (See the June 2004 issue of this newsletter for more on Risk-Based Capital.)

THE BASEL III THRESHOLDS AND THEIR IMPLEMENTATION

To the casual reader, two things are initially apparent. First, the mandated ratio of capital to risk-weighted assets seems a little low, and second, the banks are given what seems like a long time to fully comply.

The minimum threshold for what is known as "core tier 1 capital"—the best of the best kind of capital—will rise from the 2% level imposed by Basel II to 4.5%, with an additional "conservation buffer" of 2.5% to help withstand future periods of exceptional stress. This effectively raises the eventual core tier 1 capital requirement to 7% of a bank's risk-weighted assets. However, the first steps toward meeting this level need not be completed until January 2013, and reaching the full 7% level is not required until January 2019.

A further limitation is that banks will no longer be permitted to include certain items within their core capital. This means banks may have to calculate their eligible capital from a smaller base, so that the effective increase in required capital could be greater.

IS IT ENOUGH?

The architects of Basel III, not surprisingly, believe they have hit a home run. Mr. Jean-Claude Trichet, Chairman of GHOS, announced in the press release that "the agreements … are a fundamental strengthening of global capital standards," and that "their contribution to long-term financial stability and growth will be substantial."

But some impartial commentators were less charitable. For one respected economic journalist, Basel III was "the mouse that did not roar," and although the percentage of required core capital was essentially tripled, "tripling almost-nothing does not give one very much." This view was echoed elsewhere: "The regulators appear to have given in to pressure from the banking industry. I do not think that the core tier-one ratio is high enough to cope with another similar downturn."

The *Economist* highlighted the inadequacy of the previous ratio—and perhaps tacitly the new ratio—by pointing out that the Royal Bank of Scotland had a ratio of 3.5% at the end of 2007. Within a year the bank needed up to £20 billion in order to recapitalize, and the British Government had to intervene with what amounted to nationalization.

WILL REINSURERS BE UNINTENDED BENEFICIARIES?

According to Thomas Hess, chief economist at Swiss Re, the Basel III agreement will help reinsurers and that banks' previous involvement with hybrid capital, and other capital-substitute products may diminish as a result of the more stringent capital requirements. There may be some truth to this: The failed Lehman Brothers was a significant participant in the catastrophe bond market, which provides an alternative to traditional reinsurance. In the future, banks which might have been parties to such vehicles may now find the associated risk-weighting too burdensome.

SUMMARY

Getting a committee from 27 different nations to agree on anything is an achievement; the final accord does not reveal that the U.S., the U.K and Switzerland are believed to have wanted higher thresholds, or that Germany wanted more lenient levels due to idiosyncrasies in its banking system and had to be mollified with the long phase-in period.

One concern is that by discouraging regulated financial institutions from the freewheeling activity which contributed to the financial crisis, such activity will not be curtailed but re-directed to a new home, perhaps out of the current reach of regulators.

Another concern, this one voiced by the banks, is that forcing them to raise capital may mean increased lending costs for borrowers. A more private grumble is that it could mean lower banking profits and smaller employee bonuses; although investors greeted the agreement by boosting bank stocks by as much as 7%, suggesting that the new rules are not as onerous as feared.

THE NEXT STEP

The Basel III accord will now be presented at the G-20 meeting of the leaders of the world's biggest economies in November of this year, when it will be endorsed.

Individual nations can still adopt more rigorous standards of their own, and the U.K. has announced plans to do just that. Here in the U.S., the recently enacted Dodd-Frank Finance Reform Bill has already authorized the appropriate Federal Banking Agencies to "establish minimum risk-based capital requirements for insured

depository institutions … and non-bank financial companies supervised by the Board of Governors" of the Federal Reserve System. (Dodd-Frank, Section 171.)

The worst of the financial crisis may have passed, but the aftermath is still very much with us. The global banking community needed to do something, and Basel III is a step in the right direction. As the *Financial Times* commented, "Basel III is a key element in the global regulatory framework." Time will tell if the new standards are sufficient. ❖

Past issues of CUG.COMments are available.

Chicago Underwriting Group, Inc.
Web: www.cug.com
Email: info@cug.com
Phone: (312) 750-8800
Fax: (312) 750-8965

You are welcome to forward this newsletter to colleagues, clients or other interested parties.