



Summary

Banking Regulation – Raising the Bar Slowly

On September 12, the Basel Committee on Banking Supervision announced proposed changes intended to strengthen capital requirements for banks. The proposed changes are to be presented to G20 leaders in November before being implemented in phases over the next decade.

While the headline changes seem significant, in reality, most banks are already operating with core capital levels that are significantly above regulatory minimum and broadly in-line with future proposed levels. Hence the overall impact of the shift in capital minimums will be modest and this should not be a significant issue for majority of the banks.

However, as with most things, the devil is in the details and in our view, the larger effects will be determined by how individual regulators view both the need for cyclical capital buffers and the decision to impose additional capital requirement for systemic risk.

In aggregate, the shift to the new standards does not represent a material lifting of the bar. The generous transition period for the banks to comply with the new requirements should offer some breathing space and not materially affect banks' current growth plans or derail recovery of the global economy.

In general, the European banks and the Japanese banks are among the more adversely impacted. Meanwhile, the US banks, the majority of the Asia (excluding Japan) banks and the Latin American Banks are the least impacted.

The new capital rules seem to be relatively benign for banks in Asia (excluding Japan). Asia (excluding Japan) banks are well capitalized, with average common equity and tier 1 ratio above new minimum requirements. We view that the capital issues in Asia (excluding Japan) are related to growth and less about solvency of the banks. As loan growth in Asia (excluding Japan) accelerates alongside economic growth, especially in underpenetrated banking sectors such as Indonesia and China, banks' capital raising needs will be driven by strong growth in assets. Well-capitalized banks in Asia (excluding Japan) may also benefit in this operating environment, which could see their Western counterparts held back by capital constraints.

We will continue to monitor the regulatory landscape on the banking industry as it evolves and assess the potential impact and opportunities for our investors.



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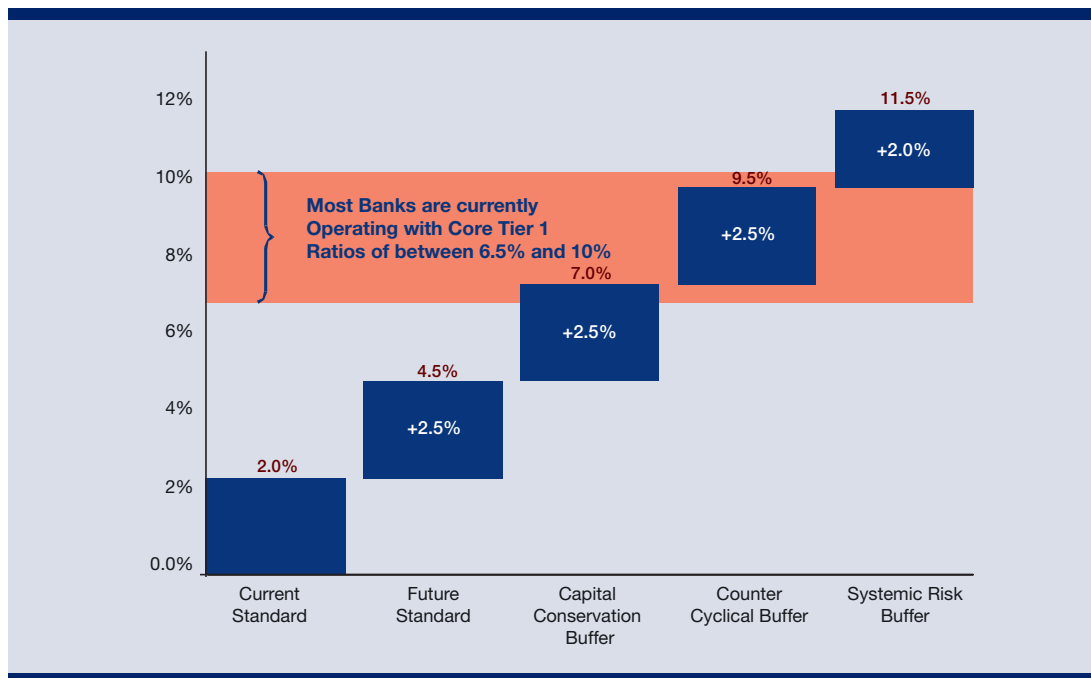
Basel Committee's Recent Proposed Changes

On September 12, the Basel Committee on Banking Supervision announced proposed changes intended to strengthen capital requirements for banks.

The key changes under the current proposals include:

- (1) lifting core Tier 1 capital requirements,
- (2) implementation of a Capital Conservation Buffer,
- (3) implementation of a Countercyclical Capital Buffer,
- (4) recommendation of implementing Systemically Important Bank Capital Buffer,
- (6) phased in deductions for Deferred Tax Assets (DTAs), Mortgage Servicing Rights (MSRs) and Investments into Financials, and
- (7) Capital Charges for Liquidity Risk.

Figure 1: Graphical Depiction of Basel Rule Changes



Source: UOB Asset Management.

The proposed changes are to be presented to G20 leaders in November before being implemented in phases over the next decade. The phasing-in will be gradual, with the new standard becoming effective from 2013 and phased in through 2018.

Analysis of the Proposed Changes

The new recommendations go a long way to clarifying the definition of core capital and providing a roadmap for individual regulators around the world to work towards.



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While the headline changes seem significant, in reality, most banks are already operating with core capital levels that are significantly above the regulatory minimum and broadly in-line with future proposed levels. Only institutions at the lower end of the spectrum or those deemed to represent systemic risks may need to lift their capital levels. Hence the overall impact of the shift in capital minimums will be modest and this should not be a significant issue for majority of the banks.

The new principles seem to go after the use of double leverage by requiring deductions from capital for investments in affiliates. Financial groups that have historically made extensive use of double leverage across their operating businesses seem to be on the losing end. Similarly, banks that have made extensive use of DTAs or MSRs to cushion capital will find it more difficult to do so in the future.

However, as with most things, the devil is in the details and in our view, the larger effects will be determined by how individual regulators view both the need for cyclical capital buffers and the decision to impose additional capital requirement for systemic risk. The latter factor here is likely to impact a large number of institutions. As has been the case in the past, the outcome will rest largely on how individual regulators interpret the guidelines and choose to implement them into their own regulatory processes.

The greatest sensitivity lies in potential changes to risk weight assumptions that the regulators permit to establish minimum capital levels as well as further regulatory push back against internal risk assumptions. Ironically, banks that had moved to Advanced IRB (Internal Rating-Based) by developing their own empirical models to quantify the required capital for credit risks approved by their local regulators are the ones that may get the greatest push back from their regulators in the future.

Similarly, banks in other jurisdictions from HK to Australia, may see the need for more capital behind certain lending activities, most notably mortgage, as regulators contemplate the impacts of falling asset prices on loss frequencies and severities, and incorporate funding risks.

The bar has not been materially lifted with proposed changes

In aggregate, the shift to the new standards does not represent a material lifting of the bar. The generous transition period for the banks to comply with the new requirements should offer some breathing space and not materially affect banks' current growth plans or derail recovery of the global economy.

For the stronger banks, just as for a well trained high jumper like Blanka Vlasik (who can clear over 2.0 meters), lifting the bar from 1.5 meters to 1.6 meters is no major challenge. But for the average high jumper or institution, the change can be life changing.

The challenges are not just the height of the bar, but understanding how the run-in works and where to take-off from. Some banks will have to go through the process of re-learning and re-calibrating their business models to adapt to this change. The proposed changes will impact the strategic choices of companies for some time.



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Asia (excluding Japan):

The new capital rules seem to be relatively benign for banks in Asia (excluding Japan). Asia (excluding Japan) banks are well capitalized, with average common equity and tier 1 ratio above new minimum requirements. Even in regions with relatively lower tier 1 ratios such as Taiwan and Korea, banks there already hold sufficient capital to meet the new regulatory requirements. Asian banks (excluding Japan) also have lower leverage ratio and more liquid balance sheets. Hence there is little immediate need to raise equity capital just to meet new regulatory standards.

We view that the capital issues in Asia (excluding Japan) are related to growth and less about solvency of the banks. As loan growth in Asia (excluding Japan) accelerates alongside economic growth, especially in underpenetrated banking sectors such as Indonesia and China, banks' capital raising needs will be driven by strong growth in assets. As Asian banks (excluding Japan) deliver on growth, it is also conceivable that the new regulatory standards could impact dividend policies. In this regard, we have already seen some banks, such as Singapore banks, moving towards stock dividend payouts in place of cash dividends to strengthen their capital position.

Well-capitalized banks in Asia (excluding Japan) may also benefit in this operating environment, which could see their Western counterparts held back by capital constraints. There are opportunities for those which are flush with capital to exploit growth opportunities which include asset gathering as well as mergers & acquisitions.

Japan:

Japanese banks will likely be most directly impacted with the deduction of DTAs from capital as they hold a large portion of capital in this form. The DTA issue also impacts Citigroup, Wells Fargo and potentially Bank of America.

Europe:

The French and Dutch financials both have historically been fairly liberal in using double leverage. The implementation of deductions for Investment in Financial Institutions will likely necessitate the need for more capital, restructuring or both.

In general, the European banks and the Japanese banks are among the more adversely impacted. Meanwhile the US banks, the majority of the Asia (excluding Japan) banks and the Latin American Banks are the least impacted.

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