2013 ECONOMY MOMENTUM CHALLENGES FOR NEXT 10 YEARS

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Abstract

Last 5 years of almost unprecedented financial market turmoil it's still generating comprehensive crisis theories, market paradigms and nevertheless unprecedented situations. The aim of this paper is to explain 2013 milestone momentum for new market rules and regulations implementation – Basel III. The expected immediate cushion factors as well the possible negative impact on financial markets is presented from financial institutions perspective. Finally, the paper seeks for an exploratory after 10 years scenario connected with imminent market evolution and tendencies.

Keywords: *Basel III, systemic risk, sovereign debt crisis, risk capital*

1. Introduction: Is the crisis over?

First target: US economy – the primary source of last global economical disruption. If we take a look at below chart (DJIA) - based on 30 largest publicly owned companies based in the United States (fortunately excepting Apple Inc.) the first answer seem to be **YES**:

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Table 1: DJIA Last 60 years evolution

(source: Bloomberg)

Compared with the historical 2007 maximum, now day's index is already running above. But just let's take a look at several economical factors compared also with October 2007 level:

- Regular Gas Price: Then \$2.75; Now \$3.73
- GDP Growth: Then +2.5%; Now +1.6%
- Americans Unemployed (in Labor Force): Then 6.7 million; Now 13.2 million
- Size of Fed's Balance Sheet: Then \$0.89 trillion; Now \$3.01 trillion
- US Debt as a Percentage of GDP: Then ~38%; Now 74.2%
- US Deficit (LTM): Then \$97 billion; Now \$975.6 billion
- Total US Debt Outstanding: Then \$9.008 trillion; Now \$16.43 trillion
- US Household Debt: Then \$13.5 trillion; Now 12.87 trillion
- Labor Force Participation Rate: Then 65.8%; Now 63.6%
- Consumer Confidence: Then 99.5; Now 69.6

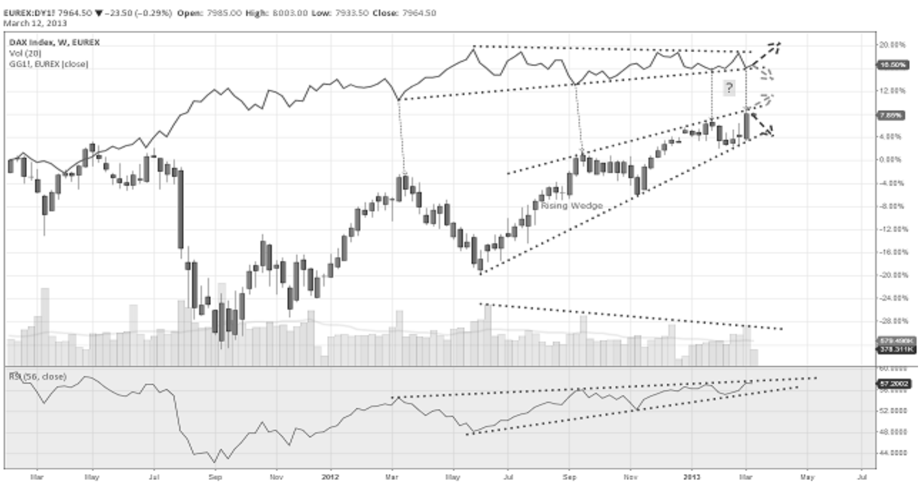
- S&P Rating of the US: Then AAA; Now AA+
- 10 Year Treasury Yield: Then 4.64%; Now 1.89%
- EURUSD: Then 1.4145; Now 1.3050
- Gold: Then $748; Now $1583
- NYSE Average LTM Volume (per day): Then 1.3 billion shares; Now 545 million shares

(Source: Zerohedge 3/5/13 for the above synopsis)

The comprehensive picture including above motioned factors is not positive at all and the immediate conclusion is that a long way is still to be done until 2007 economical balance is near.

Second look: EU economy – less affected by financial crisis in 2008-2009 but aggressive influenced by states sovereign crisis in those days.

Table 2: DAX last 2 years evolution



(source: Frankfurt Stock Exchange)

Its main performance analyzer - The DAX (Deutscher Aktien IndeX), measures the performance of the 30 largest German companies in terms of order book volume and market capitalization. It is considered the equivalent of the FT 30 and the DJIA.

The above chart showing the index at same momentum like DJIA, illustrate as well a healthy positive trend with a stable and predictable evolution. Strongly supported by auto industry and chemistry/pharmacy it gives us a peaceful image in spite of deep recession still covering Europe.

But, the recent example of Cyprus financial sector corrections combined with a negative rally on all European stock market it the best example of a still expected rock bottom situation.

Up to date situation on Cyprus biggest banking names is just put on screen the radically decisions and their immediate consequences:

Laiki Bank will be split into two sections. The first section will be regarded as the "Good Bank" and will consists of all deposits up to the amount of €100.000 per person (natural or legal) as well as all performing loans. This first section will be absorbed by Bank of Cyprus. The second section, will consists of all deposits above €100.000 as well as all non-performing loans and other business assets. This second section will be restructured and will enter in a process of liquidation. Actions will be taken for the collection of the non-performing loans, liquidation of any collateral on those loans as well as the liquidation of any other business assets that the bank owns. The funds that will be gathered will be used to compensate first of all the depositors and then, if there will be any surplus, the debenture holders and shareholders. The procedure will take some years to be completed and hopefully the end loss of the depositors will be at reasonable levels.

Bank of Cyprus will absorb the "Good Bank" section of Laiki Bank. The agreement with the EU and IMF is that the bank's Core Tier 1 capital will need to increase from 5% to 9% in order for the bank to be properly capitalized. This will be achieved with a contribution from its depositors. All deposits/balances up to €100.000 are secured and there will no contribution from them. Deposits of more than €100.000 will be subject to a compulsory conversion of a percentage of their deposits into newly issued shares of Bank Of Cyprus. So in exchange for the reduction in the bank balance of each account of above €100.000 the depositors will receive shares. Therefore, from now on the depositors will own the bank. Shares will be publicly traded in the Cyprus Stock Exchange. The percentage of this compulsory investment is not known yet as this will be determined by the final amount required after the restructuring in order to achieve the requirement of 9% Core Tier 1 Capital.

Not just relying on above reality facts, if we can't agree that the crisis is defined yet as closed and probably we will see new forms of reactions, maybe this moment is the best time to take a look back and try to forecast a new economy. The revelation momentum based on crisis knowledge is to have as primary pillar, the recession "good things":

- "Efficiency era" - now there is no company in the word that doesn't speak about losses management, resources re-allocation, consumption responsibility etc
- "Market sanitary" – hard to be accepted from the perspective of employees that loose their jobs, this process created a perfect competition field from the perspective of market adjusted standards
- "Fly to quality" – an old concept that re-enter "en vogue" at every market disruption
- "New financial standards" – Basel III regulation designed to avoid and prevent the last 10 years financial market anomalies.

In respect with all economics new rod maps and rules, Basel III seems to be the "sine qua non" condition for next 7 years in Financial Industry. According to already scheduled time frame for new financial markets policy implementation, "the future begin now" – the next chart provided by Bank for International Settlements show the tight and exactly defined capital and liquidity mandatory requirements:

Nevertheless Basel III is categorically best direct response to the global financial crisis that began in 2007 and culminated in the most severe threat to the worldwide banking system since the Great Depression. But the roots of Basel III can be traced indirectly to the forces that produced Basel I and Basel II, as well as the shortcomings of both of those frameworks in addressing the capital requirements of globally active banks.

In November 2010, after two years of severe financial market turbulences, the member states of the Group of Twenty (G20) officially approved Basel III, which represents a clear exit from the philosophy and substance of Basel I and II. It's not surprising that Basel III seeks for considerable increase in quality and quantity of capital that banks must hold. Beside these mandatory guidelines is the Basel comprehensive reassessment of risk coverage assumptions and administration procedures. But, probably the most innovative (and controversial from many point of views) component of Basel III, is the creation of a set of system-wide macro prudential measures. While the reforms and rules introduced in Basel I and II were almost exclusively made at a micro prudential or bank-specific level, Basel III introduces, for the very first time a set of tools and standards at the macro prudential level—such as a countercyclical buffer and a universal leverage ratio—to address systemic risk within the global financial system. In addition, the systemic risk players (Banks) were clear defined by measurable standards and unambiguous characteristics. The on going schedule of Basel III is illustrated in next chart:

Table 3: Basel III phases as per Basel Committee schedule

Basel Committee on Banking Supervision
BANK FOR INTERNATIONAL SETTLEMENTS

Basel III phase-in arrangements
(All dates are as of 1 January)

	Phases	2013	2014	2015	2016	2017	2018	2019
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				4.5%
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%
	Minimum Total Capital		8.0%					8.0%
	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	10.5%
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013					
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	100%
	Net stable funding ratio						Introduce minimum standard	

* Including amounts exceeding the limit for deferred tax assets (DTAs), mortgage servicing rights (MSRs) and financials.
– – transition periods

(source: Basel Committee on Banking Supervision, Bank for International Settlements)

So now there is Basel III on the table of each executive from financial sector, designed in light of the past lessons, regulators and players have learned from the financial crisis and, it is hoped, ready to serve as a resource to correct the collapse of its short-lived predecessor (Basel II). As per a.m. chart the main changes, to be phased in, from 2013-19, are as follows:

- A change in the definition of the assets that can be counted as regulatory capital (capital must now be in the form of common share capital or retained earnings)
- Increased capital requirements that cover a wider range of risk types, such as the risks associated with securitization and counter-party credit risk.
- A new leverage ratio (from P&L perspective) that restricts the amount of money banks can borrow.
- New rules on bank liquidity. These will require banks to hold more cash on a day-to-day basis as well as over the longer term.
- New rules on risk management and governance.
- Enhanced disclosure requirements relating to the securitization of assets and the sponsorship of off-balance-sheet vehicles
- Pressures to further increase the stock of capital they hold while at the same time reducing their reliance on debt finance.

Table 4: Basel Committee master plan

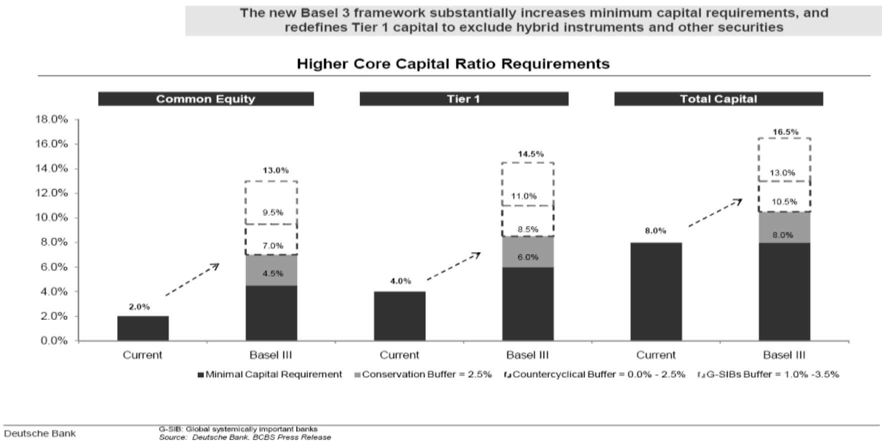
Basel Committee on Banking Supervision reforms - Basel III

Strengthens microprudential regulation and supervision, and adds a macroprudential overlay that includes capital buffers.

	Capital					Liquidity
	Pillar 1			Pillar 2	Pillar 3	
	Capital	Risk coverage	Containing leverage	Risk management and supervision	Market discipline	Global liquidity standard and supervisory monitoring
All Banks	**Quality and level of capital** Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions. **Capital loss absorption at the point of non-viability** Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard. **Capital conservation buffer** Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range. **Countercyclical buffer** Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.	**Securitisations** Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures. **Trading book** Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account. **Counterparty credit risk** Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures. **Bank exposures to central counterparties (CCPs)** The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.	**Leverage ratio** A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.	**Supplemental Pillar 2 requirements.** Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.	**Revised Pillar 3 disclosures requirements** The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.	**Liquidity coverage ratio** The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. **Net stable funding ratio** The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding. **Principles for Sound Liquidity Risk Management and Supervision** The Committee's 2008 guidance *Principles for Sound Liquidity Risk Management and Supervision* takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations. **Supervisory monitoring** The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.
SIFIs	In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.					

(source: Basel Committee on Banking Supervision, Bank for International Settlements)

Table 5: Basel III capital requirements



(source: Deutsche Bank study - The Road to Basel 3)

Designed between 2008 and 2010 for further unforeseen events, those changes didn't succeed to bring a positive impact on European sovereign debt crisis due to short time of early implementation. Even so, assuming that a systemic bank could have reasonable time prior any market adverse movement, how can it raise the capital required by Basel III?

The common sense based solution is simply to reduce their liabilities (fact easily observed at all major financial players). Essentially, this means lending less and investing less money in the financial markets. But this is unlikely to represent a good option for economic growth or domestic wealth and also does little for the banks themselves, which have to take a degree of risk to make a profit and satisfy their shareholders. At first sight, the increase in tight rules and regulations (as a consequence of a poor constrain before) create a paradigm base for a new possible / probable financial crisis – when, who, or what, might be considered the real cause – the "new" banks, their regulators or perhaps even a combination of both? As already seen with Basel II, however, the accidental consequences of regulation can sometimes be worse than the problems it is designed to solve.

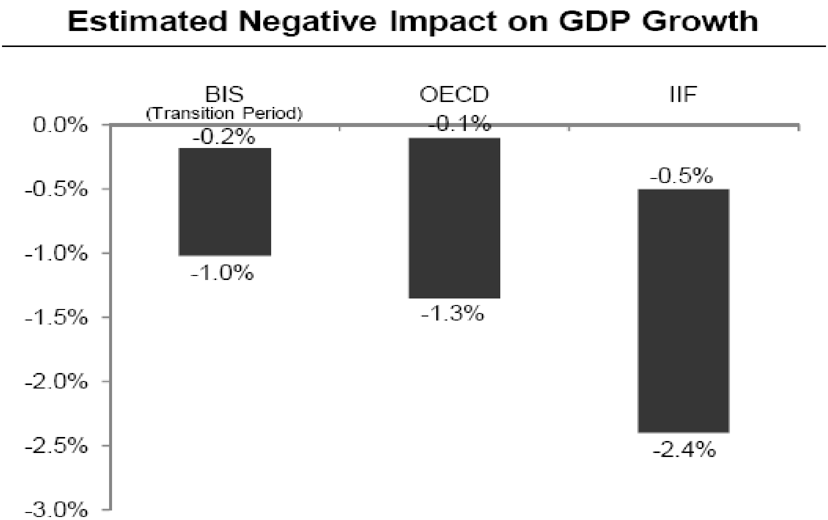
Consistent with mentioned assumptions, the real economy (GDP) is already impacted through 3 main channels:

- Reduced lending volumes

- Increased interest costs
- Enhanced financial system stability

A estimation of this impact in GDP after Basel III implementation stages according to important financial organisms:

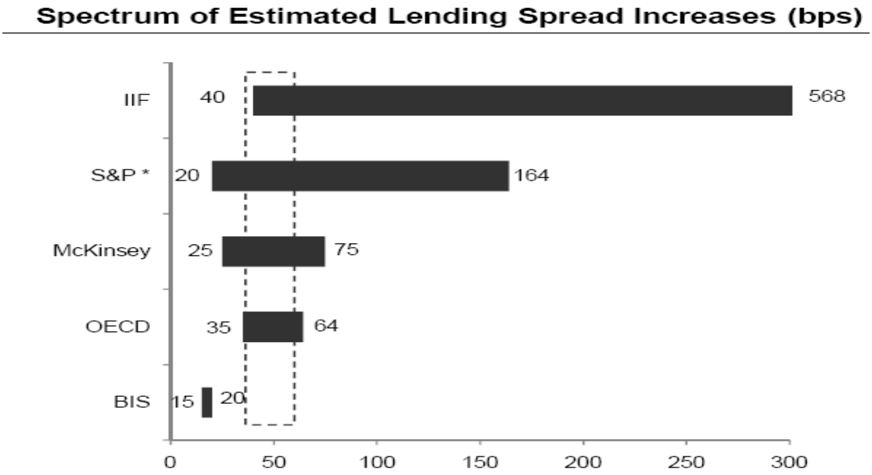
Table 6: GDP evolution on Basel III



(source: Deutsche Bank study - The Road to Basel 3)

The negative estimation on financial costs increase is also expected:

Table 7: Expected margins (interest) raise on Basel II rules implementation



(source: Deutsche Bank study - The Road to Basel 3)

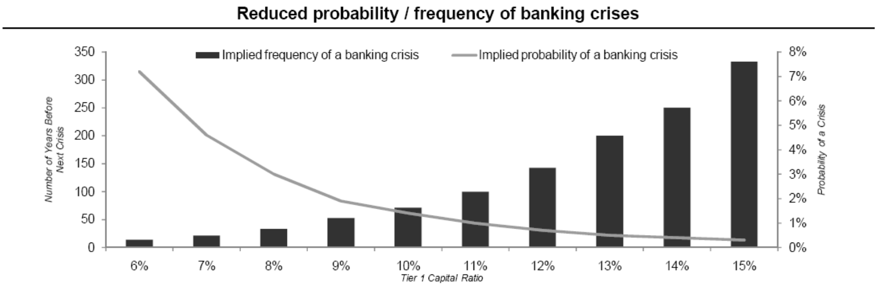
On same pattern, Fitch Ratings estimates the 29 global systemically important financial institutions (G-SIFI), which have a combined USD 47 trillion in assets, may need to raise USD 566 billion in common equity to meet new capital standards. This is a 23 percent increase against their aggregate common equity of USD 2.5 trillion.

In this respect, the probability and frequency of a banking crisis decreases proportionately to increases in regulatory Tier 1 capital ratios:

– Higher capital buffers improve banking sector resilience to economic instability

– Banks better “equipped” to withstand market crashes

Table 8: Expected positive trend on crises prevention after Basel implementation



(source: Deutsche Bank study - The Road to Basel 3)

Finally assuming that Basel III will provide the necessary balance in financial and global markets gradually until 2020, the following question is on the lips of many analysts and economical daily observers: “What’s next”?
- a economy exclusively based on same patterns like net profit, ROE, RORC ?
- a two digits grow chased every year?
- staff reduction beyond any imagination (99% automatic processes)

or

- sustainable development in respect with nature limitations (raw materials and water resources)
- an expected healthy profit connected with future generations growing needs
- synergetic alliances between old competitors
- holistic communications of corporations “real“ values and missions
- social responsibility based development
- transparency and traceability of supply chain
- CO2 footprint in economy analysis versus “green energy trend” (ex: Wind farms)
- Offshore solutions limitation (regions with single development options)

Perhaps a positive answer to mentioned challenges is driving us to so call “ethics economy” and more or less “ideal economy”. How far or how close we are at this essential economical momentum from this point, is difficult to estimate in an economical evaluation still insufficient detached to "ceteris paribus" axiom.

Consistent with this long term shut, at this moment probably the best we can do, is to only speculate about next 24 months major economy picture adjustments: Mr. Obama, **Trans-Atlantic Free Trade zone with EU**? **Offshore area boomerang effect** after International Consortium of Investigative Journalists reveals tens of thousands of people in more than 170 countries and territories linked to offshore companies and trusts for profit dissimulation purposes? **BRICS Challenges Unipolar World and US Dollar Hegemony?** (BRICS hit some major western sore spots by announcing the formation of a $50 billion jointly-funded development bank to rival the IMF and World Bank, at annual Summit in Durban, South Africa in late March)

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