BLOG

Eased capital requirements comfort US Banks

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The Federal Reserve (Fed) has eased capital requirements for banks to support the economy, which is heavily affected by the current COVID-19 pandemic. Accordingly, the Fed has temporarily excluded deposits at the Fed and US Treasury Securities when the supplementary leverage is calculated by global systemically important banks, an opportune decision, as banks have no need to hold capital at the current emergency level against the assets that have the least credit risk. This relaxation will assist the Fed and banks to support the US economy, which already contracted by -4.8% in 1Q20 owing to the restrictions on economic activities as a measure to curtail the spread of COVID-19.

The capital requirement of a bank is determined by the risk-weighted assets (RWAs) that the bank holds. Therefore, banks should maintain a sufficient capital level, proportionate to the riskier assets that the bank holds, to absorb the losses that may arise from loan defaults and investment failures to reduce the risk of insolvency. Furthermore, Basel IV was to be introduced by regulators in 2022 to address the issues regarding the current capital requirement calculation.

However, banks find it very challenging to meet the RWA requirements during a crisis, as the asset portfolios of banks could deteriorate owing to the rise of risk levels associated with assets. Particularly, if the credit ratings of the corporates in which banks have invested or lent are downgraded immediately, banks’ RWAs increase accordingly. Therefore, banks need to maintain a high level of capital to meet the capital requirements. If banks do not have the capital buffers to meet the required level, they will most likely not be able to raise capital from the market during an economic downturn. As a result, the capital level may fall below the minimum level of requirement, sending the wrong signal to depositors, thus leading to deposit withdrawals.

Banks should revisit their lending portfolios to review what the high-risk lending sectors are. For example, owing to the impact of the COVID-19 pandemic, leisure, tourism, travel, and entertainment are at a high-risk level. Moreover, unsecured loans and secured loans holding collaterals with diminished market value will likely have a greater risk, as defaults, payment delays, and covenant breaches are more probable.

However, when moratoriums are offered to borrowers who face repayment difficulties due to cash flow constraints, those loans will not be considered as non-performing loans during the moratorium period. Therefore, the lending quality of the loans that are granted moratoriums will not be immediately affected. Banks, as well as regulators, have to carry out detailed analysis to decide the terms and conditions on these moratoriums.

On the other hand, banks cannot restrict lending activities, as they have to support businesses and individuals to prevent permanent damage to the economy. Availability of credit will ensure faster economic recovery once the pandemic crisis subdues or falls to a manageable level.

An improvement in accounting and reporting of financial assets and liabilities was required after the last financial crisis; as a result, IFRS 9 was introduced. Loan loss provision initiated accordingly to estimate the lifetime expected credit losses on a financial instrument and to recognise it appropriately. However, the expected credit losses on a lending portfolio increase owing to the current COVID-19 impact. Nevertheless, it is essential to consider the support, such as moratorium schemes, given by the government to corporates and individuals before deciding the provisions, as the current environment is subject to change positively once the COVID-19 outbreak is controlled. There is no need to allocate massive loan loss provisions for the loan portfolios that are affected temporarily, as they could be reversed once the economy turns around.

Mitigating measures, such as providing moratorium plans and relaxing on covenants for loans, should be considered by banks for temporarily effected loan portfolios until the economic volatility settles, rather than increasing loan loss provisions, as that may reduce banks' profitability and capital levels.

Basel IV addresses the issues regarding the calculation of regulatory capital requirements and improves the quality and risk sensitivity of the standardised approaches for credit risk and operational risk. Basel IV discourages internal models to assess credit, market, and operational risks, thus increasing the reliability of risk assessment.

Currently, banks contend with multiple challenges, and the implementation of Basel IV in 2022 will likely create additional pressure on banks, as capital requirements will be restricted further. Therefore, regulators have decided to postpone the same to 2023 or later. However, the timely implementation of Basel IV is also extremely important without adding extra burden to banks, as it improves consistency in assessing risks, facilitating easy comparison throughout the global banking system.

Acuity's View and Possible Solutions That Can Be Offered

The close monitoring of banks' credit portfolios is essential, as many lending clients are affected by the current economic downturn. Consequently, default rates will rise, requiring banks to increase their provisions for loan losses, ultimately affecting banks' profitability and capital reserves. Acuity Knowledge Partners can support banks by analysing its clients' business models and financials comprehensively and providing accurate solutions to banks to minimise the negative impact arising from loan defaults.

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