

## **After The Crisis: Strengthening Banks' Capital Framework**

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THE RECENT financial crisis has revealed weaknesses in the banking supervision framework, particularly the capital adequacy requirements. After feedback from several sides, including the Financial Stability Board and the G20 leaders, the Basel Committee on Banking Supervision (BCBS) addressed this issue in consultation document headed "Strengthen the resilience of the banking sector," published in December.

Under the new framework, issues of quality, consistency and transparency of capital base are raised. This will ensure that large internationally active banks are in a better position to absorb losses on both a going concern and gone concern basis.

To achieve such an overarching objective, the BCBS proposed that so called Tier 1 capital, the core measure of a bank's financial strength, must comprise of common shares and retained earnings. During the financial crisis, banks reported high Tier 1 ratios but with a low level of common equities. When the crisis deepened, huge losses and write downs directly reduced retained earnings, leading banks to crash. To rectify the problem, banks should increase the proportion of common shares in their capital structures as this are deemed the highest quality component of capital, being able to absorb losses when they occur, having full flexibility of dividend payments, and no maturity.

Other components of Tier 1 capital will also be strengthened to better absorb losses. As for Tier 2, the definition will be simplified, with important characteristics being subordinated debt of depositors and general creditors, and original maturities of at least five years.

In addition, under the new framework, the effects of accounting transactions, such as recognition of employee benefits, goodwill and intangible assets, will be reflected in regulatory capital. This makes the implementation of a single set of accounting standards-the International Financial Reporting Standards -increasingly important. Comments on the consultative document will be received by April 16.

To assess the impact of new rules on bank's capital and performance, the BCBS recently ordered a study which is now underway across Europe. When the results are in, the new framework for banking capital is expected to be finalised by the end of the year, Its implementation will be phased in as financial conditions improve and economic recovery is assured but is expected to be complete by 2012.

The impact of the new capital regulations on Thai banks is expected to be less than on their counterparts in the US and Europe, as Thai banks' capital mainly comprises common stocks. Hybrid Tier 1 and Tier 2 capital instruments contribute only a small portion of the capital of a few banks. Overall, the quality of Thai banks' capital can be considered high. Nevertheless, the changes present a good opportunity for Thai banks to reappraise their capital structures. This will ensure their strength and competitiveness in the global financial markets as the open financial system comes in to being.

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**(The views expressed are the author's own.)**

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