WEATHERING THE TEMPEST: THE IMPACT OF THE BASEL III CAPITAL ACCORD ON ASSET FINANCE

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The Second Capital Accord of the Basel Committee on Banking Supervision ("Basel II") was intended to address capital sufficiency amongst institutions lending in risky sectors. Since its introduction, the world economy has gone through categorically unique depressions, hallmarked by the 2008 financial crises. Scrambling to respond to the unique challenges posed by unprecedented failures throughout the international banking community, the Basel Committee's latest charge has been to revamp its prior accords while formulating new methodologies intended to avoid the reoccurrence of the catastrophes of the past four years: regulations that comprise the Third Basel Capital Accord ("Basel III"). These new prescriptions on asset-based financing have been criticized by some as oppressive and a hindrance to commerce, yet praised by others as a hopeful dose of preventive medicine that will foster long-term stability.[1] Ultimately, the practical effects on access to capital in asset finance transactions posed by Basel III will reflect the banking sector's need to comply with its terms and responses to capital needs addressed from sources inside and outside the scope of Basel III's applicability. This article is intended to: (1) illustrate the critical differences between the current (Second) Basel Accord and the impending Third Accord in the historical context of the financial crises of 2007-2009 and the resulting environment that has evolved since; (2) analyze the anticipated impact of the Third Accord on the specific activity of asset-based finance; and (3) identify practical scenarios that conceptualize the implementation of Third Accord requirements in hypothetical transactions that are both commercially feasible and Accord-compliant. In many aspects, this article is intended as the next installment of an article published in 2004, which addressed the

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[1] *See* Adrian Blundell-Wignall & Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity*, 2010 OECD JOURNAL-FINANCIAL MARKET TRENDS, no. 1, 2010; Michael Watt, *Basel III Blamed for Aircraft Financing Drought*, RISK MAGAZINE (May 9, 2012), *available at* http://www.risk.net/risk-magazine/news/2172653/basel-iii-blamed-aircraft-financing-drought; Rachel Witkowski, *Basel III Could Further Stymie Already Tepid Bank M&A*, AM. BANKER (Aug. 16, 2012), http://www.americanbanker.com/issues/177_158/basel-could-further-stymie-tepid-bank-manda-1051863-1.html.

anticipated impact of Basel II on institutional lending in transportation finance and used shipping finance as its primary paradigm.[2]

I. TESTED BY THE TEMPEST: BASEL II AND THE WORLD ECONOMIES

No Shelter From the Storm: the 2007-2009 Financial Crisis

Basel II effectively functions as a capital sufficiency mandate intended to ensure lending institutions maintain sufficient reserves to cover loss at various tiers of risk.[3] Through the implementation of its provisions, banks and other global institutions subject to regulation through Basel II grappled with these sufficiency requirements while maintaining asset-based finance portfolios that provided sought-after returns. Long-term asset finance projects were to be evaluated according to the effect that on and off-balance sheet items would pose to the capital sufficiency requirements imposed by the Bank for International Settlements ("BIS").

In late 2008, the now well-known horror of institutional collapse in the banking sector began to occur, epitomized by the insolvency and collapse of Lehman Brothers.[4] The widely accepted primary cause of the meltdown was over-speculation in securities backed by debts subject to massive default by reason of borrower unworthiness: a phenomenon that tested the veracity of the Basel II requirements up to their practical limits, and then beyond.[5] However, the inherent flaws in Basel II revealed themselves, in the opinions of some, by the fact that its regulations did little to prevent the crisis.[6]

Within weeks of the Lehman Brothers collapse, the threat of the international banking community collapsing in on itself spurred the Basel Committee to begin working on

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[2] *See generally,* Peter Measures & Angelo L. Rosa, *Outpacing the Tempest: The Consequences of Basle II on Institutional Lending in Shipping Finance Transactions*, 6 TENN. J. BUS. L. 94 (2004).

[3] The objectives of Basel II focus on a more risk sensitive system of regulation. The first pillar of the new Accord, concerning minimum capital adequacy is tied to two crucial processes: risk evaluation and its corresponding translation into the required amount of capital that must be held in accordance with the new requirements. In broad terms, the challenges that Basel II will present will result from requirements that companies exchange internal capital assessment programs when it comes to evaluating risk. Stacking a portfolio with lucrative, high-risk investments without regard to capital sufficiency requirements will no longer be feasible. *Id.* at 95, n. 6; *see also* BASEL COMMITTEE ON BANKING SUPERVISION, OVERVIEW OF THE NEW BASEL CAPITAL ACCORD, 1 (2001) (providing a general overview of the New Accord and its intended effects); GEORGE ALEXANDER WALKER, INTERNATIONAL BANKING REGULATION: LAW, POLICY AND PRACTICE 569-603 (2001) (analyzing the provisions of the Capital Accord in relation to its 1988 predecessor).

[4] Justin Fox, *Three Lessons of the Lehman Brothers Collapse*, TIME (Sep. 15, 2009), http://www.time.com/time/business/article/0,8599,1923197,00.html.

[5] *See* Shawn Baldwin, *Basel Barriers: How Capital Requirements Would Impede Progress in the Sovereign Debt Crisis*, FORBES (Oct. 15, 2012), http://www.forbes.com/sites/shawnbaldwin/2012/10/15/basel-barriers/

[6] *Id.*

new accord provisions designed to address the catastrophic loss that had contracted institutional lending and locked down capital holdings.[7] Starting in a reactionary stance and then evolving into (arguably) a more solutions-minded approach, the Basel Committee began to piece together a protocol to help ensure that the ills of the financial crisis would be avoided in the future.

II. BACK TO THE DRAWING BOARD: BASEL III FRAMEWORKS

Nuts and Bolts of Basel III

In the wake of the incendiary events of late 2008, the Basel Committee set about responding to the crisis through the announcement of a "comprehensive strategy."[8] In that announcement, the BIS announced a means for addressing what the Committee defined as "fundamental weaknesses revealed by the financial market crisis related to regulation, supervision, and risk management of internationally-active banks."[9] The proposed policies announced by the Committee were to be premised upon enhancing Tier 1 capital under Basel II, implementing "shock absorbers" intended to quell pro-cyclicality, and building upon the Basel II requirements to strengthen risk management.[10] By March 2009, the Committee had advanced discussions on revisions to proposed new regulations to include superior coverage of risk exposure of individual banks through monitoring securitization and derivative activities,[11] capital buffers intended to counteract cyclical fluctuations to be "built up in good times and drawn down in stress,"[12] and emphasis upon system-wide supervision intended to maintain system-wide perspective on risk management and overall market health.[13]

Changes in the calculation of loan risk factors under Basel II are widely considered to have at least contributed to the "credit bubble" effect leading up to the financial crisis that culminated in late 2008.[14] This makes up the primary distinguishing factor between Basel II and Basel III.[15] While regulators have grappled with addressing the deficiencies that Basel II was intended to avoid, other parties have tried to take what could arguably be a more practical assessment of the market crisis and determine just how practical solutions might be

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[7] BANK FOR INTERNATIONAL SETTLEMENTS, *Comprehensive Strategy to Address the Lessons of the Banking Crisis Announced by the Basel Committee*, 20 November 2008, http://www.bis.org/press/p081120.htm.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] BANK FOR INTERNATIONAL SETTLEMENTS, *Initiatives in Response to the Crisis by the Basel Committee*, 30 March 2009, http://www.bis.org/press/p090330.htm.
[12] *Id.*
[13] *See id.*
[14] Baldwin, *supra* note 5.
[15] *Id.*

implemented.[16] With the pragmatic acknowledgment that sudden change in asset quality and value can eliminate bank capital, connections between banks within the international system is, predictably, the source of a domino effect in asset devaluation, loss of liquidity and, consequently, failures based upon the simple yet damning factor that, when banks run out of money, crisis is imminent.[17] Arguing that Basel II had never been properly implemented as intended, the Organisation for Economic Co-Operation and Development ("OECD") contended that changes to boost capital held for market risk were modified from their original model and arguably were insufficient.[18] Another failure identified by the OECD, was that the Basel II requirements failed to capture both on and off-balance sheet risks, or, in other words, failed to address sources of loss germane to the destabilization.[19]

Criticism of Basel III's Practical Effects

The proposal for capital reform is criticized for not addressing risk-weighting in a practical way.[20] Without integration of off-balance sheet exposure into the overall risk-assessment formula, there will be persistent inaccuracy in the application of the Basel formulas, again undermining the entire intent of the regulatory scheme as a whole.[21] Furthermore, the OECD commended the Basel Committee for addressing pro-cyclicality yet pointed out the inherent difficulties in attempting to practically implement macro-prudential activity standards.[22] However, throughout the commercial banking sector (in plain terms, the parties with money on the street), widespread criticism has evolved, based primarily around the argument that Basel III is simply too theoretical to work in real-life scenarios where banks are expected to lend in order to generate revenue and characterize assets in balance sheet reporting in ways that reflect both the activities themselves and comply with regulatory mandates concerning capital sufficiency and reporting.[23]

One of the primary criticisms of Basel III was the perceived lack of real-world perspective on merger and acquisition activity, meaning that, while the theoretical concepts of capital buffers and consequences for falling below the prescribed levels work in theory, they stifle potential deals given that banking institutions will need to retain capital purely out

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[16] *See, e.g.,* Blundell-Wignall & Atkinson, *supra* note 1.
[17] *Id.* at 2.
[18] *See id.* at 7 (identifying that average capital requirement for banks would rise by 11.5% but median requirements would rise only by 3.2%).
[19] *Id.* at 8.
[20] *Id.* at 10.
[21] *Id.*
[22] *See id.* (pointing out that such recommendations are "likely to perform poorly in practice" on the basis that "leads and lags in modeling credit, and the problem of structural changed caused by financial innovation").
[23] *See* Baldwin, *supra* note 5; Donna Borak, *Can Basel III Be Saved?*, AM. BANKER, Sep. 7, 2012, *available at* http://www.americanbanker.com/issues/177_174/can-basel-iii-be-saved-karen-shaw-petrou-believes-it-can-1052468-1.html?zkPrintable=1&nopagination=1.

of compliance necessity, which could otherwise be deployed for funding.[24] On a much smaller scale (i.e. lending to small businesses), small community-based banks have voiced strong opposition to the implementation of Basel III regulations, particularly given that their lending portfolio is geared toward smaller capitalization projects and narrower margins that would be narrowed further (or even eviscerated completely) by the capital retention requirements.[25] This argument has been postulated more in the United States than elsewhere in the world subject to the Basel III rules given the prolific number of small community banks in comparison to other countries.[26] Nevertheless, commentary has been made on the basis that an international, "one-size-fits-all" approach to capital adequacy lacks a sense of practical implementation.[27]

Another impact relating to Basel III implementation lies in the broader macro-economic perspective. The OECD issued a predictive white-paper in February 2011 estimating the long term effect on gross domestic product to be a reduction of 0.05% to 0.15% per year as the cost of funding increases due to adjustments made necessary by Basel III.[28] In a similar study, the Basel Committee itself predicted a decline of 0.22% for the first thirty-five fiscal quarters before any growth would be anticipated in connection with the regulations.[29]

Again, however, there has been criticism of what many consider to be a myopic view of the real macroeconomic consequences of Basel III—for instance, the criticism of Basel III's liquidity coverage ratio (or "LCR"), which theoretically is intended to buffer against insolvency (*a la* Lehman Brothers).[30] In August 2012, the European Central Bank began advocating a less stringent liquidity requirement on the basis that contraction of capital would further exacerbate the financial crises experienced throughout the Eurozone.[31]

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[24] Witkowski, *supra* note 1.
[25] Robert H. Smith, *Where's the Logic in Subjecting Small Banks to Basel III?*, AM. BANKER (Aug. 20, 2012), http://www.americanbanker.com/bankthink/wheres-the-logic-in-subjecting-small-banks-to-basel-III-1051893-1.html; *see also* Donna Borak & Rachel Witkowski, *Small Banks Win More Time in Basel III Dispute*, AM. BANKER (Aug. 9, 2012), http://www.americanbanker.com/issues/177_153/regulators-give-small-bankers-more-time-on-basel-III-plan-1051670-1.html (identifying the fact that federal banking regulators granted Independent Community Banks of America additional time to offer comment on the proposed implementation of the Basel III requirements).
[26] Smith, *supra* note 18.
[27] *Id.*
[28] Patrick Slovik & Boris Cournède, *Macroeconomic Impact of Basel III*, OECD ECONOMICS DEPARTMENT WORKING PAPERS NO. 844 (2011), *available at* http://dx.doi.org/10.1787%2F5kghwnhkkjs8-en.
[29] MACROECONOMIC ASSESSMENT GROUP, FINAL REPORT, ASSESSING THE MACROECONOMIC IMPACT OF THE TRANSITION TO STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS, 9-10 (2010).
[30] Blundell-Wignall & Atkinson, *supra* note 1, at 19.
[31] Jim Brunsden, *ECB Said to Urge Weaker Basel Liquidity Rule*, BLOOMBERG NEWS (Aug. 28, 2012), http://www.bloomberg.com/news/2012-08-27/ecb-said-to-urge-weaker-basel-liquidity-rule-on-crisis-concerns.html.

Additionally, the United States banking community reacted to the proposed restrictions on the use of instruments such as brokered deposits (and their grouping into short-term assets required to be held as a component of an institution's minimum liquidity) by concluding that the proposal, if implemented, would contract a bank's ability to provide critical lending across all industries.[32]

III. THE REAL BUSINESS IMPACT OF BASEL III ON TRANSPORT FINANCE

The practical effect of this debate concerning Basel III and the exercise of putting capital into the market through asset-based financing is that it reveals how the rubber hits the proverbial road. Given that the Basel III scheme requires banks to hold capital requirements and maintain liquidity, there is a discouragement from lending. Commentators have already identified trending in financing that indicates lessors and capital market lenders are playing a more significant role in transportation finance than banks.[33] In the aviation sector specifically, key market players have criticized the Basel Committee for dis-incentivizing lending by banks for aircraft finance projects.[34]

The conception is that the banking exercise of correlating short-term deposits to short-term loans in order to satisfy capital sufficiency requirements eliminates, by its very nature, the ability to make long-term loans that fulfill the business needs of sectors whose financial health is dependent upon the ability to spread the cost of capital out over a longer period of time than regulations might conceivably allow. This reflects an earlier criticism of post-financial crisis brainstorming by the Basel Committee in that, whereas there were perceived insufficiencies in the "quality of capital," there has been a failure to address leveraged ratios in relation to capital weighting.[35] With limitations on how far banks can leverage assets, including the timeframe in which such activities can take place, banks are left with the limited range of motion for asset-based financing, with activity confined to short-term (i.e. mezzanine-type) financing.[36] As Basel III makes lending in transport sectors

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[32] *See* Christopher Whalen, *Basel III Liquidity Rules May Kill Short-Term Deposits*, AM. BANKER. (Nov. 1, 2012), http://www.americanbanker.com/bankthink/basel-iii-liquidity-rules-may-kill-short-term-deposit-market-1053915-1.html.

[33] Watt, *supra* note 1.

[34] *See id.* (quoting Kostya Zolutusky from Boeing Capital Corporation, who commented that "The regulators appear to have done a good job in preventing any future crisis in the banking space. Unfortunately, they have also greatly reduced the scope of banking in general and its ability to serve the real economy.").

[35] *See* Blundell-Wignall & Atkinson, *supra* note 1, at 15 (noting that a key component of the interactive dialogue between the Basel Committee and the banking community will relate to setting leverage ratios at a level where banks can maintain sufficient capital to conduct their activities and comply with regulatory mandates).

[36] *See* Watt, *supra* note 1 (quoting John Slattery of Embraer, who commented that Western European banks, which are faster to implement Basel III's requirements, will prefer short-term financing).

prohibitive at best, banks are left with few options but to either restrict lending terms or divest themselves of their transport finance portfolios altogether.[37]

As a practical matter, Basel III requires banks to hold capital at the regulatory-defined levels, with long-term lending requiring long-term capital holdings that, in essence, necessitates holding more funding in reserves than the amount of funding that is being lent.[38] From the perspective of borrowers, there has been an evolving attitude that places long-term business relationships (in good times and bad) at odds with the requirements of Basel III. Whereas banking relationships entailed working through scenarios of default with the objective of preserving long-term relationships,[39] the Basel III requirements make such arrangements impractical as banks grow reluctant to lend.[40] For example, a shipping finance scenario funded by a Basel-regulated banking institution that encountered potential default circumstances would be subject to the regulatory mandates applicable to capital sufficiency, likely to the point of tying the hands of the lender and requiring recourse on default versus more lenient work-out terms.

Further practical effects of the Basel III formulation evolution have been seen throughout the asset finance community. Banking risk has been redefined from building blended portfolios that include longer-term asset financing to excluding such transactions from lending portfolios altogether.[41] On the more extreme end of the spectrum, some banks are being driven out of the lending market for transportation finance altogether; even institutions with long-standing prominence in transportation finance such as Royal Bank of Scotland have divested themselves of aircraft-lending portfolios.[42]

For example, an operator wishing to enter into long-term financing for an aircraft will typically seek loans with maturity between six and twelve years and lending amounts around $50 million. A single bank lending in such a category would be required to maintain comparable levels of capital, which can pose hindrances to bank operations on a wider scale.[43] With the ratios of Tier 1 common equity to risk-weighted assets set to increase under Basel III, banks will need to spread risk among a number of participants to manage

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[37] *See id.*
[38] *See id.*
[39] Michael Watt, *Basel III Takes a Bite Out of Aircraft and Shipping Finance*, RISK MAGAZINE, May 4, 2012, *available at* http://www.risk.net/risk-magazine/feature/2169913/basel-iii-takes-bite-aircraft-shipping-finance.
[40] *See id.* (quoting Peter Sand of Baltic International Maritime Council who commented on the impending Basel III requirements as having a negative effect on the availability and pricing of financing).
[41] *Id.*
[42] *Id.*
[43] *Id.*

risk at acceptable levels or tie up significant capital in reserve in order to continue participating in such transactions.

One of the primary challenges is that the standardization inherent in Basel III is viewed in some quarters as overly primitive, specifically the perception is that the liquidity risk is too simple a diagnosis of a problem and that the increase to the capital holding requirement is too basic a solution.[44] Though committed to implementing the mandates of Basel III, the FDIC has expressed agreement with this assessment of the proposed regulations,[45] arguing that the previous two capital accords failed to prevent the most recent financial crisis and boldly stating that the proposed third capital accord would not prevent the next one.[46]

By mid-September 2012, discussion had evolved to the point where many regulators began to question whether Basel III, as currently articulated, could be saved from near-universal scrutiny due to its attempt to standardize international banking according to a single scheme.[47] Ultimately, the Basel Committee has resolved to broaden the liquidity requirements to accommodate the realities that banks cannot feasibly hold funds in the quantities originally proposed while maintaining active lending to ensure financial success.[48] These revisions are purported to expand the range of assets eligible as high quality liquid assets (or "HQLA") and revise assumptions regarding capital flow rates to "better reflect actual experience in times of stress."[49] Further, the Basel Committee agreed to revise the schedule for phasing in the requirements of the Third Capital Accord.[50]

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[44] *See* Karen Shaw Petrou, *Why Going 'Back to Basics' Is the Wrong Answer to Basel*, AM. BANKER, Sep. 19, 2012, at 8, *available at* http://www.americanbanker.com/bankthink/why-back-to-basics-is-the-wrong-answer-to-basel-1052777-1.html?zkPrintable=1&nopagination=1 (arguing that emphasis on high liquidity on-balance sheet asset is advocated with disregard for previously problematic off-balance sheet asset problems that resulted from Basel I loopholes).

[45] *See* Alan Kline, *Basel III Should Be Scrapped, Hoenig Says*, AM. BANKER, Sep. 14, 2012, at 4, *available at* http://www.americanbanker.com/issues/177_179/basel-iii-should-be-scrapped-says-hoenig-1052668-1.html?zkPrintable=1&nopagination=1 (illustrating comments made by FDIC Board Member, Thomas Hoenig, that the Basel Committee should "start over").

[46] *Id.*

[47] *See* Borak, *supra* note 23 (reporting commentary from the banking sector in favor of placing the responsibility for evaluating banking relationships on a county-to-country basis and leaving regulatory standards to the discretion of each individual nation's banking regulators).

[48] *See Basel Committee Releases Revised Version of Basel III's Liquidity Coverage Ratio*, BIS (Jan. 7, 2013), http://www.bis.org/press/p130107.htm;*see also* Brooke Masters, *Banks Await Basel III Liquidity Rules*, FIN. TIMES (Jan. 6, 2013, 12:56 PM), http://www.ft.com/cms/s/0/1c4a46cc-57fa-11e2-b997-00144feab49a.html#axzz2INFlne00.

[49] *Group of Governors and Heads of Supervision Endorses Revised Liquidity Standard for Banks*, BIS (Jan. 6, 2013), http://www.bis.org/press/p130106.htm.

[50] *Id.*

These practical reactions to practical concerns show great promise; however, where one door closes, another often opens. The shift away from bank financing to the transportation sector on account of the prohibitions of Basel III will create new and/or expanded opportunities for capital markets and investment funds that are not subject to the regulations applicable to banks.[51] In many respects, this mirrors the opportunities that the stringencies of Basel II posed for financing sources; the withdrawal of banks from financing areas such as shipping created opportunities for other entities to service these sectors, including boutique investment banks and similarly aligned sources.[52]

Irrespective of the regulatory debate, the real-world consequences endure as access to capital is simply going to be restricted as banks are forced to comply with those requirements. The balance between encouraging fiscal prudence and stifling the flow of capital is likely to continue driving long-term asset lending further into the boutique and venture capital arena. While such a regulatory scheme may prove self-defeating, voiced preferences for briefly stated and firmly enforced rules[53] will likely continue to be overlooked, necessitating new and innovative methods of asset financing. While banks will struggle to comply with regulatory mandates, there is a balancing act to be accomplished between innovating to grow the banking business, developing products offered in response to demands by the borrower market that the banking industry serves, and conducting business in a way that facilitates profit yet curtails the dangerous risk of capital droughts and institutional failure.

IV. CONCLUSION

Basel III provides an epitomic example of the tension between regulation and the attempt to do business in a regulated industry. From industry perspectives, Basel III disincentives investment by making participation unaffordable. In so doing, the regulations seek to beat banking activities into more precisely defined channels of acceptable lending behavior. In order to survive, banks must yield to regulatory mandates.

While the regulations themselves are likely to be inevitable, the funds flowing into the industry through other channels hold a promise of success for the transportation finance sector. Other financing parties will enjoy the benefits of return on investment where ships and aircraft and other such assets are concerned. Until more survivable balances between lending timeframes and capital levels are formulated to strike a sustainable compromise, the Basel Committee is likely to be a conductor for retraction at worst and spreading of risk at best. It also remains to be seen whether the regulations are likely to contribute to the much needed improvement of the macro-economic health in the banking sector—both as a

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[51] *See* Watt, *supra* note 1.
[52] *See* Measures & Rosa, *supra* note 3, at 112 n.101.
[53] *See* Shaw Petrou, *supra* note 44.

remedy for scenarios that prior Basel regulations did not avoid and preventive medicine for future crises. However, the profitability of asset-finance lending is likely to be attributed less and less to the traditional banking sector.