

Basel Amended Proposals on Capital and Liquidity Requirements

August 2010

Summary

- On July 26, 2010, the BCBS announced it reached “broad agreement” on capital and liquidity reform proposals initially published as part of the Basel III framework exposure drafts in December 2009
- The announcement describes in summary form changes to the December 2009 proposals
- The amendments respond to many concerns raised by financial institutions in their comments on the December 2009 proposals

Summary of Amendments

- The amendments:
 - Do not require a complete deduction from Tier 1 common equity for mortgage servicing rights, deferred tax assets or investments in common shares of unconsolidated financial institutions, subject to a cap
 - Retain a leverage ratio but preliminarily “calibrate” the leverage ratio at 3% and adopt phase-in “milestones” with bank level disclosure of the ratio commencing January 1, 2015, and actual application of the ratio as a Pillar 1 capital measure commencing on January 1, 2018
 - In the liquidity coverage ratio (LCR), lower the floors for assumed run-off rates for deposits and certain other sources of funds and expand – as a new concept of “Level 2” liquid assets – the scope of assets includible within the “stock of liquid assets” in the numerator of the ratio
 - Propose that the Basel Committee issues a revised net stable funding ratio (NSFR) by the end of 2010

Comments Not Addressed

- The amendments do not address a number of other industry concerns and proposals, including:
 - The required deduction from Tier 1 common equity for other intangibles, like credit card account relationships, and for defined benefit pension fund assets
 - The capital surcharge on “systemically significant” banks
 - The potentially destabilizing effect that disclosure of the LCR and NSFR could have on some banks
 - The broad concerns expressed by many commenters with the capital buffer proposals

Background

- The Basel Committee’s December 2009 proposals consisted of two consultative documents:
 - “*Strengthening the Resilience of the Banking Sector*” – addressed proposed changes to bank capital requirements
 - “*International Framework for Liquidity Risk Measurement, Standards and Monitoring*” – proposed specific liquidity tests that, although similar in some respects to tests historically applied by banks, going forward would be required by regulation
- Financial institutions, both in the United States and abroad, had very serious concerns with the December 2009 proposals
- The amendments announced on July 26, 2010 were not unanimously approved by the Basel Committee

Background (cont'd)

- A footnote in the annex notes that one country – identified in press reports to be Germany – “still has concerns and has reserved its position until the decisions on calibration and phase-in arrangements are finalized in September”
- For U.S. banks, the regulation of capital (both in quantity and components) and of liquidity will be significantly affected by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd- Frank Act), signed into law by President Obama on July 21, 2010
- The interplay between the Dodd-Frank Act and Basel III presents a number of interesting challenges

Amendments to Capital Proposals

Deductions from Tier 1 Capital

- The December 2009 capital proposals introduced a new definition of “common equity” and proposed that, going forward, capital regulations would include a minimum ratio of common equity to risk-weighted assets
- Common equity was very conservatively defined to require, among other things:
 - a dollar-for-dollar deduction from common equity for all intangible assets (including mortgage servicing rights)
 - deferred tax assets and investments above designated thresholds in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation
 - unrealized gains and losses that are recognized on the balance sheet but under existing regulations are “filtered out” from Tier 1 Capital in the United States

Amendments to Capital Proposals (cont'd)

- The amendments provide some relief, for example:
 - Instead of requiring a full dollar-for-dollar deduction from common equity for mortgage servicing rights, deferred tax assets and investments above the initially proposed thresholds in unconsolidated financial institutions, the amendments do not require a full deduction of those components
 - Mortgage servicing rights, deferred tax assets arising from timing differences, and “significant investments” in the common shares of unconsolidated financial institutions are not deducted, subject to two caps:
 - The first cap, for any one of those three components, is 10% of the bank’s common equity
 - The second cap, for the three components in the aggregate, is 15% of the bank’s common equity

Amendments to Capital Proposals (cont'd)

- The December 2009 proposals excluded any minority interests from inclusion in common equity
- The amendments allow inclusion of some minority interests in a subsidiary that is a bank in the capital of the bank holding company; however, the language in the amendments is very general and leaves specifics to a later date

Counterparty Credit Risk

- The December 2009 capital proposals included a variety of provisions modifying the treatment of counterparty credit risk (CCR) in the two internal ratings-based approaches in Basel II
- The proposals included the construction of a “bond equivalent approach” to calculating the credit valuation adjustment (CVA) with respect to counterparty risk, and the application of a 1.25 multiplier to the asset value correlation of exposures to large regulated financial firms (defined as those having assets of at least \$25 billion) and to all exposures to unregulated firms, regardless of size
- Industry participants that commented on the CCR proposals had concerns both with respect to the overall approach (including, in the case of the bond equivalent CVA, its failure to recognize hedging) and specific aspects, including the 1.25 multiplier

Amendments to Capital Proposals

- The amendments retain the bond equivalent approach and the 1.25 multiplier but outline in general terms four changes:
 - modify the bond equivalent approach “to address hedging, risk capture, effective maturity and double counting”
 - retain the 1.25 asset value correlation multiplier, but raise the threshold for its application to large regulated financial firms to those with assets of at least \$100 billion, instead of \$25 billion
 - eliminate the 5x multiplier to the CVA that was included in the December 2009 proposals and viewed by commentators as excessive
 - in connection with legislative and regulatory reforms that will force or encourage the move of derivative exposures to central counterparties (including, for example, the Dodd-Frank Act), impose “a modest risk weight, for example in the 1-3% range,” to banks’ mark-to-marketing collateral exposures to those counterparties

Leverage Ratio

- The December 2009 capital proposals introduced a leverage ratio as an international standard
 - As proposed, would have included a very broad scope of off-balance sheet commitments in its denominator, including converting 100% of unconditionally cancellable commitments and the gross amount of derivatives (including credit derivatives) to a liability exposure includible in the denominator of the ratio
 - Did not include a proposed minimum ratio (that is, “calibration”)

Leverage Ratio (cont'd)

- The amendments attempt to address the major concerns, although their language is qualified
 - During a testing period (referred to as a “parallel run period”) pending a final calibration of the leverage ratio, apply and assess a minimum Tier 1 leverage ratio of 3%
 - Apply a 10% credit conversion factor to unconditionally cancellable off-balance sheet commitments, “subject to further review to ensure that the 10% CCF is appropriately conservative based on historical experience”
 - Permit legally enforceable netting of derivative exposures (including credit derivatives), so that only the net positive amount is included in the denominator of the ratio
 - With respect to derivatives exposures, add to the denominator “a simple measure of potential future exposure based on the standardized factors of the current exposure method”
 - Calculate the leverage ratio as an average over each quarter

Leverage Ratio (cont'd)

- The amendments describe a transition period before the leverage ratio becomes fully applicable on January 1, 2018 and contemplate that adjustments may be made to the proposal
- The “milestones” in the transition to the full implementation of the leverage ratio are:
 - supervisory monitoring commencing on January 1, 2011
 - a “parallel run” commencing January 1, 2013 and running until January 1, 2017
 - during this period, the leverage ratio and its components will be tracked, including its behavior relative to the risk-based capital requirements
 - disclosure by banks of the leverage ratio and its components starting January 1, 2015
 - an effective final leverage ratio as a Pillar 1 component on January 1, 2018

Other Capital-Related Provisions

- The amendments reference a number of other matters addressed in the December 2009 capital proposals, but without setting forth specific amendments or refinements, including:
 - **Buffers:** The December 2009 capital proposals included a very general outline for a buffer above minimum requirements (referred to in the amendments as a “conservation buffer”); the amendments simply note that that proposal “remains unchanged”
 - On July 16, 2010, the Basel Committee released a countercyclical buffer proposal that would be in addition to the buffer described in the December 2009 capital proposals
 - The amendments simply state that the “two proposals will be finalized jointly by the end of this year”

Other Capital-Related Provisions (cont'd)

- **Forward-Looking Provisioning:** The December 2009 capital proposals noted the Basel Committee's interest in encouraging forward-looking provisioning but also noted the challenges under different accounting regimes in addressing the interplay between forward-looking provisioning and capital requirements
 - The amendments do not spell out a proposal in this regard but note that the Basel Committee has sent a letter to the IASB on the topic and "is in close dialogue" with the IASB
 - There is no similar reference to the FASB
- **Contingent Capital and Related Proposals:** The amendments do not include specific proposals on contingent capital or other instruments that convert to common shares or might be written off in times of distress

Amendments to Liquidity Proposals

- The December 2009 liquidity proposals described two measures of liquidity risk exposure, one based on a 30-day time horizon and the other addressing longer-term structural liquidity mismatches over a one-year time period
 - The first, labeled the “Liquidity Coverage Ratio” (LCR), was defined as the ratio (for a bank) of its “stock of high-quality liquid assets” divided by a measure of its “net cash outflows over a 30-day time period”
 - The second, labeled the “Net Stable Funding Ratio” (NSFR), was defined as the ratio (for a bank) of its “available amount of stable funding” divided by its “required amount of stable funding”

Amendments to Liquidity Proposals (cont'd)

- The amendments:
 - do not address the rigidity or disclosure concerns expressed by banks in their comment letters
 - make adjustments to the calculation of the LCR
 - recognize that significant modifications need to be made to the NSFR
 - change the timeline for dealing with the NSFR to one that contemplates a new (but not final) proposed NSFR by December 31, 2010

Liquidity Coverage Ratio

- The amendments describe a number of modifications to the LCR as initially proposed, qualified by the comment that the Basel Committee “will review the impact of these changes to ensure that they deliver a rigorous overall liquidity standard,” including:
 - lower the run-off factor floors to 5% for stable deposits and 10% for less stable deposits (compared to the 7.5% and 15%, respectively, run-off factors initially proposed)
 - introduce a 25% run-off factor for funds relating to custody, clearing and settlement activities, as well as selected cash management activities, with financial institution counterparties
 - specify that the run-off factor for unsecured wholesale funding provided by a broader range of nonfinancial customers – not just “corporate customers” as provided in the December 2009 liquidity proposals, but also sovereigns, central banks and public sector entities – are subject to a 75% run-off factor instead of the 100% run-off factor provided for in the initial proposals (and which still appears to apply to unsecured wholesale funding provided by financial entities)

Liquidity Coverage Ratio (cont'd)

- lower the assumed draw-down rate on committed credit facilities to retail customers and small and medium-size enterprises to 5% instead of the 10% provided for in the December 2009 liquidity proposal
- lower the assumed draw-down rate on credit lines to sovereigns, central banks and public sector entities to 10% instead of the 100% provided for in the December 2009 liquidity proposals
- for purposes of the definition of liquid assets includible in the numerator of the LCR, allow the inclusion of domestic sovereign debt for sovereigns that are not 0% risk-weighted if issued in a foreign currency, to the extent matching the currency needs of the bank's operations in that jurisdiction
- introduce a new concept of "Level 2" liquid assets that may constitute up to 40% of the stock of all liquid assets includible in the numerator for the LCR
 - Level 2 liquid assets will be subject to a 15% haircut and include (i) public sector entity obligations that are 20% risk-weighted (for example, in the United States, instruments issued by government sponsored entities such as FNMA or Freddie Mac) and (ii) high-quality non-financial and corporate covered bonds not issued by the bank itself (with the amendments giving as an example such securities that are rated "AA-" and above)

Net Stable Funding Ratio

- The amendments state that the Basel Committee remains committed to the introduction of the NSFR as a longer-term structural complement to the LCR but notes that the NSFR as initially proposed needs to be modified
- The adjustments under consideration are to:
 - raise the ASF factors applicable to stable and less stable retail and small business deposits from 85% and 70%, as initially proposed, to 90% and 80%, respectively
 - lower the RSF factor applicable to seasoned residential mortgage loan to 65% from the 100% provided for in the December 2009 liquidity proposals
 - lower the extent to which off-balance sheet commitments would need to be pre-funded by lowering the 10% RSF factor for such commitments in the December 2009 liquidity proposals to 5%
 - implement an “observation phase” to address any unintended consequences before finalizing and introducing a revised NSFR as a minimum standard by January 1, 2018

Conclusions

- The release does not request comment on the amendments or address whether the Basel Committee will publish for further comment revised proposals reflecting the amendments
- The amendments do not set forth proposed minimum ratios of common equity, Tier 1 capital or total capital to risk-weighted assets, nor do they add more detail to the regulatory buffers
- The release states that the Governors and Heads of Supervision have agreed to finalize the calibration and phase-in arrangements at their meeting in September