

Basel Framework

March 2010

Overview

- On December 17, 2009, the BCBS announced far-reaching proposals for comment. The comment period is open until April 16, 2010.
- The new Basel framework (referred to as Basel III) responds to the comments and statements of the G20, as well as of policymakers and commentators, and their collective assessments regarding loopholes or weaknesses that may have contributed to the financial crisis.

Background

Recent events

- Financial institution capital structures are still a work in progress
- The events which put stress on financial institution capital are well known
 - Bankruptcies: Lehman Brothers
 - Forced Sales: Bear Stearns, Merrill Lynch
 - Effective nationalism (AIG, FNMA, Freddie Mac)
 - Significant Government Support/Equity Ownership
 - Bank of America, Citigroup
 - Goldman, JP Morgan, Morgan Stanley etc.
- To date, financial institutions and regulators have reacted in a variety of ways: raising new and different types of capital, proposing still more new types of capital and legislative initiatives

Brief history

- Early 19th Century—Unregulated “wildcat” banks carried upwards of 40% capital to meet withdrawals of circulating notes
- National Bank Act, Federal Reserve Act and Federal Deposit Insurance Act ultimately led to capital ratios of 5% to 8%
- 1981—First regulatory numerical ratios of 5% to 6%—not risk weighted
- 1983—International Lending Supervision Act required regulatory capital ratios

Brief history (cont'd)

- 1988 Basel Capital Accord tried to make capital more precise and to reduce competitive advantages
 - Numerator—What counts as capital
 - Tier 1 Core
 - Tier 2 Supplementary
 - Denominator—What you count capital against is risk weighted
 - 0%—Cash and cash equivalents
 - 20%—Short-term bank deposits
 - 50%—1-4 family mortgages
 - 100%—C&I loans
 - 10%—Well capitalized
 - 6%—Leverage ratio

Basel I Numerator Tier 1

- Tier 1 at least 4% of risk-weighted assets
- Common equity
- Noncumulative perpetual preferred stock
- Qualifying cumulative perpetual preferred stock up to 25%—15% for internationally active BHCs in 2011
- Minority interests in consolidated subsidiaries
- Minus goodwill and other intangibles

Basel II

- Numerator is the same
- Denominator
 - Risk weights change
 - Standardized approach
 - Internal ratings-based approach for qualifying banks
 - Model driven
- Capital reduction for qualifying BHCs?
 - Confidence in models has declined
 - Concern for overall capital has increased

Basel Numerator Tier 2

- Tier 2—Limited to 100% of Tier 1
- Allowance for loan and lease losses up to 1.25% of risk-weighted assets
- Perpetual preferred stock
- Hybrid instruments and equity contract notes
- Subordinated debt and intermediate term preferred stock—up to 50% of Tier 1

Basel III Framework

Four major components

- Quality, consistency and transparency of the capital base
 - Greater emphasis placed on the common equity component of Tier 1 capital
 - Simplification of Tier 2
 - Elimination of Tier 3
 - Detailed regulatory capital disclosure requirements
- Enhancement of risk coverage through enhanced capital requirements for counterparty credit risk
 - Enhanced risk coverage will address issues that arise in connection with the use of derivatives, repos, and securities financing arrangements
- Changes to non-risk adjusted leverage ratio
 - This ratio will supplement the Basel II risk capital framework
- Measures to improve countercyclical capital framework

Quality, Consistency & Transparency

- The definition of Tier 1 capital is moving toward the definition of “tangible common equity.”
- Tier 1 capital (referred to as going concern capital) must consist primarily of common equity + retained earnings – regulatory adjustments (including deductions of tangible assets).
- Non-equity Tier 1 must be subordinated and have discretionary dividends/coupons with no incentive to redeem in times of stress.
- There will be an explicit minimum ratio of common equity to risk weighted assets.
- The proposals include specific eligibility criteria for common equity.

Eligibility Criteria for Common Equity

- The proposal includes a list of 14 criteria to be satisfied in order for common shares to be included as common equity.
- Common shares must be fully subordinated to all other claims in liquidation, with no fixed or capped claim on liquidation, except at the discretion of the issuing bank. There cannot be any obligation on the issuer's part to repurchase or redeem the securities.
- Several “innovative” Tier 1 instruments would be phased out, including, for example, step up instruments; cumulative preferred stock; and trust preferred stock. Grandfathering period is uncertain.

Tier 1 Additional Going Concern Capital

- Tier 1 Additional Going Concern Capital also is defined by reference to specific criteria, including that:
 - The instrument is subordinated to depositor claims;
 - The instrument is perpetual, with no maturity date or incentive to redeem;
 - The instrument may be redeemable at the issuer's option only after five years and their subject to certain conditions
 - The instrument must permit discretion on the issuer's part to cancel payments
 - The instrument cannot impede recapitalization

Hybrid Capital

- The Basel III framework would (as noted) limit the types of hybrid instruments that would qualify as Tier 1 Capital.
 - Consistent with many of the ongoing CEBS proposals relating to hybrid Tier 1 eligibility criteria
 - Responsive to the view that hybrid instruments did not provide sufficient “loss absorbency” during periods of financial stress
 - Rating agencies also are re-evaluating hybrid securities
- The current hybrid market may be affected by the uncertainty arising from Basel III proposals
 - S&P, for example, has stated that it will use Basel date (Dec 17, 2009) as demarcation line for “grandfathering” of hybrid ratings

Contingent Capital

- Basel III recommends that additional studies be undertaken that focus on contingent capital instruments
- In Europe, there are fewer tax impediments associated with the issuance of contingent capital instruments than in the United States, where additional discussion and analysis needs to be undertaken
- BCBS scheduled to discuss specific proposals at its July 2010 meeting

Regulatory Adjustments to Be Harmonized

- Currently, regulatory adjustments vary across jurisdictions. The framework will provide for harmonized adjustments that will be applied to the common equity component of Tier 1 (in contrast to applying currently to Tier 1 + Tier 2).
- Harmonized adjustments will include:
 - Minority interests;
 - May motivate banks to dispose of minority stakes in affiliates or buy affiliates outright
 - Deferred tax assets;
 - In the U.S., this would have a significant impact
 - Shortfall in reserves;
 - Goodwill and other tangibles (including mortgage servicing rights);
 - Unrealized gains and losses;
 - Gains and losses due to changes in own credit risk; and
 - Defined benefit pension fund assets and liabilities.

Tier 2 and Tier 3 Capital

- The framework would simplify Tier 2 capital by establishing a single set of eligibility criteria for Tier 2 capital and eliminating Upper and Lower Tier 2.
- In order to qualify as Tier 2 capital, Tier 2 must be subordinated to depositors and general creditors; not secured; not guaranteed; must have an original maturity of at least five years; and must be callable by the issuer only after a minimum of five years.
- Tier 3 will be eliminated completely.

Transparency

- The framework will require disclosure of detailed capital information, including a reconciliation of all regulatory capital elements with the issuer's audited financial statements.
- The framework also would require separate disclosure of all regulatory adjustments.

Increased Capital Requirements for Counterparty Credit Risk

- A significant portion of the proposals discuss issues relating to the regulatory capital treatment of counterparty credit risk (CCR) arising from a bank's derivatives, repurchase agreements and securities financing activities.
- There are quite a number of measures designed to strengthen risk coverage outlined in the proposals, including:
 - a requirement that banks determine capital charges for CCR using stressed inputs;
 - a capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty (a credit valuation adjustment); and
 - higher capital charges for bilateral OTC exposures to financial institutions

Increased Capital Requirements for Counterparty Credit Risk (cont'd)

- The proposal would provide incentives to move OTC derivatives contracts to central counterparties and exchanges
- Requires banks to determine capital charges for CCR using stressed inputs, similar to the approach used for determining stressed VaR for market risk

Declined Reliance on Rating Agencies

- Consistent with the rule changes and proposed rule making in the U.S. and the EU relating to rating agency regulation and oversight, the proposals seek to mitigate reliance by issuers on ratings.
- Banks will be required to perform their own internal assessments of externally rated exposures.
- Banks will need to undertake risk mitigation measures.
- The proposals would incorporate key elements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

Leverage ratio

- The proposals focus on use of a leverage ratio as a supplementary measure to the Basel risk based capital framework.
- The ratio would require a minimum level of capital relative to total assets.
- The leverage ratio is intended to limit the overall leverage levels so that there is no non-risk based backstop based on gross exposure.
- Capital Measure: **numerator** of the leverage ratio (capital) would consist of only high quality capital that is generally consistent with the revised definition of Tier 1 capital set forth in the proposal.
- Total Exposure Measure: generally, the proposal indicates that the **denominator** of the leverage ratio (the total exposures) would be determined in accordance with applicable accounting rules.

Leverage ratio (cont'd)

- High quality liquid assets includes cash and cash-like instruments in the measure of exposure.
- Securitization exposures would be counted in a manner generally consistent with accounting treatment.
- Derivatives exposures would either follow the applicable accounting treatment or use the current exposure method.
- Other off-balance sheet items included: commitments, unconditionally cancellable commitments, direct credit substitutes.

Cyclicality, Capital Buffers and Provisioning

- Proposal will require forward-looking provisioning, which promotes stronger loan loss provisioning
- Stress-tested capital buffers and capital distribution limits: requires banks to hold capital buffers above the regulatory minimum capital requirements and to establish “capital conservation standards”
- Intended to limit excessive credit growth

Liquidity Proposals

- The liquidity proposals incorporate three principal elements
 - A liquidity coverage ratio
 - A net stable funding ratio
 - Monitoring tools

Liquidity Coverage Ratio

- The ratio is intended to ensure that a bank maintains adequate levels of unencumbered high quality assets to meet its liquidity needs
 - Measured as the ratio of the bank's high quality liquid assets (numerator), divided by its net cash outflows over a 30-day period (denominator);
 - The high quality assets included in the numerator include only
 - Cash, central bank reserves that can be accessed during times of stress, marketable securities meeting certain criteria, and government or central bank debt
 - The denominator will be calculated by taking into account certain “run-off factors”

Net stable funding ratio

- This ratio is intended to focus on medium and long-term funding (over a one-year time period)
 - The ratio of available stable funding to required stable funding must equal or exceed 100%
 - The ratio is calculated as the available amount of stable funding (the numerator), divided by the required amount of stable funding (the denominator)
 - Available stable funding is the total amount of the bank's capital, preferred stock with a maturity of one year or more, liabilities with effective maturities of one year or more and "stable" non-maturity and/or term deposits with maturities of less than one year
 - The required amount of stable funding is the sum of the value of the assets held by the bank, after converting certain off-balance sheet exposures to asset equivalents, multiplied by a required stable funding (RSF) factor that reflects the amount of the asset that could be monetized under stress

Monitoring tools

- The proposals discuss several monitoring tools that are intended to improve assessments of liquidity risk. The metrics address:
 - Contractual maturity mismatch;
 - Funding concentration;
 - Available unencumbered assets; and
 - Market-related monitoring tools

Timing

- Consultation until April 16, 2010
- Comprehensive impact assessment during the first half of 2010
- Fully calibrated standards by the end of 2010
- Implementation expected by the end of 2012

Expected Outcomes

- Will likely require banks to raise more capital
 - May be accomplished through asset sales
 - May be accomplished through capital-raising
 - fewer instruments will qualify as good Tier 1
- Will likely increase the cost of capital for banks
- May affect economic growth
- May constrain dividend payments
- The deduction for deferred tax assets is unexpected
- The additional charges for various counterparty credit risks, when considered together with other pending regulatory changes relating to derivatives, will have the effect of increasing funding costs and reducing leverage