

UPDATE ON BASEL III REQUIREMENTS -- Basel Denominator and Liquidity Issues

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Outline

- Basel III:
 - New capital requirements – the “numerator”
 - effect of proposals on hybrid capital
 - capital conservation ratio
 - countercyclical buffer
 - leverage ratio
 - Impact on banking organization exposures – the “denominator”
 - Counterparty credit risk (CCR) requirements
 - New liquidity requirements and ratios
 - Credit ratings and securitization activities
 - Derivatives activities
 - Disclosure issues

Basel III Proposals

- BCBS consultative document – December 2009
- BIS announcement and annex – July 2010
- August 2010 consultation on “gone concern” capital requirements
- BCBS agree calibration of capital standards – September 2010
- BCBS proposals endorsed at G20 meeting in Seoul in November 2010
- Final Basel III rules published on December 16. 2010
 - Requirements relating to loss absorbency at point of non viability published on January 13, 2011.

Counterparty Credit Risk (“CCR”) Framework

- Basel III makes significant changes to CCR framework that become effective on a transitional basis beginning in 2013.
- CCR measures designed to strengthen risk coverage include:
 - Expected positive exposure (EPE) with stressed parameters to address “wrong-way” risk (i.e., where a future exposure to a specific counterparty is highly correlated with the counterparty’s probability of default); available to banks that have been approved to use the Internal Model Method (“IMM Banks”) for counterparty credit exposures under Basel II.
 - Requirement that banks determine capital charges for CCR using stressed inputs.
 - Capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty (credit valuation adjustment, or CVA); some distinctions between treatment of IMM banks and other banks that are to use a standardized CVA capital charge.

Counterparty Credit Risk (“CCR”) Framework

- CCR measures designed to strengthen risk coverage (cont.):
 - Minimum holding periods (margin period of risk) for netting exposures with a single counterparty.
 - Higher capital charges for bilateral OTC exposures to financial institutions.
 - New requirements to improve the operational performance of the collateral department (applicable primarily to IMM Banks). Includes policies and procedures for calculating and managing collateral activities, new MIS requirements, and regular independent audits/reviews of the CCR management process.
 - Enhanced model validation and back testing requirements for CCR exposure management.

CCR Framework (cont.)

- Banks to determine capital charges for CCR using stressed inputs.
- In addition, a 1.25 asset value correlation multiplier is applied to:
 - Large regulated financial institutions whose total assets are at least U.S.\$100bn
 - All “unregulated” financial institutions, regardless of size (defined to include entities engaged in the “management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitisation, investments, financial custody, central counterparty services, proprietary trading and other financial services activities identified by supervisors.”

CCR Framework (cont.)

- Central counterparties (CCPs):
 - Recognizing the ongoing International Organization of Securities Commissions (“IOSCO”) work on CCP standards, Basel III will apply a regulatory capital treatment for exposures to CCPs based in part on the compliance of the CCP with the enhanced Committee on Payment and Settlement Systems (“CPSS”)-IOSCO standards.
 - Standards to be finalized during 2011 once consultation and an impact study are complete and after CPSS-IOSCO has completed the update of standards applicable to CCPs. They will come into effect at the same time as other counterparty credit risk reforms.
 - In December 2010, the BCBS published a consultative document relating to capitalization of exposures to CCPs, in which it has proposed a risk weight of 2% for collateral and mark-to-market exposures to CCPs.

External Credit Ratings

- BCBS believes that aspects of existing capital framework encouraged investors to place too much reliance on external credit ratings.
- BCBS Basel III proposals include:
 - Issue specific rating assessment may only be applied to unrated issues by the same issuer that ranks pari passu or senior to rated issue.
 - Banks to develop methodologies to assess credit risk of securitisation exposures even if rated.
 - Amendments to eligibility criteria for entities providing credit protection.
 - Elimination of certain “cliff effects” associated with credit risk mitigation practices

External Credit Ratings (cont.)

- Proposals (cont.)
 - Banks should use ratings of CRAs consistently for both risk weighting and risk management purposes.
 - Incorporation of IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies.
 - Banks should use ratings of credit rating agencies consistently for both risk weighting and risk management purposes.
- Interaction with Dodd-Frank Act provisions (sections 939 and 939A) limiting banking organization reliance on external credit ratings
 - Section 939: Removal of statutory references to external ratings in various federal statutes.
 - Section 939A: Financial agencies are required to review regulations requiring assessment of creditworthiness of exposures that refer to external credit ratings, and remove regulatory references to reliance on external ratings.

New Liquidity Ratio Requirements

- Two proposed liquidity ratios:
 - Short term liquidity coverage ratio (“LCR”).
 - Longer-term net stable funding ratio (“NSFR”).
- Liquidity coverage ratio:
 - High quality liquid assets to cover net cash outflows over 30 day period.
 - Builds on traditional internal methodologies used by banks to assess exposure to contingent liability events.
 - Defined as stock of “high quality liquid assets” divided by “total net cash outflows” for next 30 days.
 - In calculation of cash outflows, different run off rates are used for different types of deposits.

Liquidity Ratios (cont.)

- LCR assets:
 - High quality liquid assets consist of assets that “can be easily and immediately converted into cash at little or no loss of value.”
 - In general, high quality liquid assets cannot be encumbered or commingled.
 - Certain high quality liquid assets in the nature of cash, accessible central bank reserves and marketable securities in the nature of claims on qualifying sovereign/OECD/multilateral exposures (“level 1 assets”) may be included on asset side on an unlimited undiscounted basis.
 - Other high quality liquid assets (“level 2 assets”) must comprise no more than 40% of the overall stock and must have a minimum 15% haircut.
- Observation period for liquidity coverage ratio commences in 2011 and ratio to be introduced at start of 2015.

Liquidity Ratios (cont.)

- Net stable funding ratio:
 - Designed to promote resilience over a period of one year.
 - Builds on net liquid asset and cash capital methodologies used by internationally active banks.
 - Available stable funding (“ASF”) must be at least equal to required stable funding (“RSF”).
- NSFR should be reported at least quarterly
- NSFR will be a minimum standard by January 1, 2018

Securitizations

- Basel-related provisions governing securitizations in general:
 - Heightened risk weights for some lower-rated and unrated securitization exposures.
 - More conservative collateral haircuts for securitization collateral with respect to counterparty exposures.
 - Additional specific risk haircuts for securitization transactions and exposures.
 - In part, these changes build upon previous changes to increase capital requirements for resecuritization exposures (e.g., some CDOs and ABCP programs).

Securitizations (cont.)

- Impact of securitization risk retention requirements on regulatory capital
 - Mandatory risk retention requirements will increase levels of regulatory capital that banking organizations must maintain with respect to their securitization activities.
 - Consolidation impact of risk retention requirements is in flux and will be affected by future developments and regulatory/private sector actions (e.g., application of FASB FAS Nos. 166 and 167 (accounting for securitizations and special purpose vehicles)).
 - For instance, the U.S. agencies' response to capital requirements for off-balance sheet activities that are now consolidated under FAS 166 and 167 has been to require full capital against the assets. Net effect is an increase in capital against securitizations.

Derivatives Activities

- Elements of Basel III will have a direct effect on the capital consequences of banking organization OTC derivatives activities:
 - See discussion of CCR framework above.
 - New requirements are intended to require increased regulatory capital support for banking organization exposures to CCR through their OTC derivatives activities – a concern that was highlighted during the 2008 financial crisis.
 - CVAs required under the new rules, which will vary according to the likelihood of counterparty default and qualified credit mitigation activities, will directly capture OTC derivatives exposures and may significantly increase the risk-weighted assets denominator for banks with significant OTC derivatives trading and dealing operations.
 - Certain types of derivatives transactions, however, may be treated as qualified hedges that can mitigate the effects of required CVAs.
 - There may also be mitigating benefits associated with trading/clearing of OTC derivatives trading through qualified central counterparties (CCPs), where associated capital requirements may be modest.

Disclosure Issues

- SEC proposals/guidance to require issuer disclosures of short-term borrowings and liquidity/capital resources (September 2010)
 - *Short-term borrowings*: a registrant would be required to provide, in a separately captioned subsection of Management's Discussion and Analysis of Financial Condition and Results of Operations, a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information. Disclosures would have to be made in annual and quarterly reports, proxy or information statements that include financial statements, registration statements under the Securities Exchange Act, and registration statements under the Securities Act.
 - *Liquidity/capital resources*: Building on prior SEC guidance issued in 2003, and to improve disclosures of liquidity and capital resources in the MD&A and facilitate investor understanding of the liquidity and funding risks facing issuers, SEC had published interpretive guidance on MD&A requirements.

Concluding Observations

- Basel III supplements but does not replace Basel II.
- Much of Basel III concerns itself with the numerator (elements of capital) but impact on the denominator (banking book activities) may be significant.
- Basel III is a work in progress. BCBS and participating supervisors still have significant work to do:
 - Going-concern proposals
 - Treatment of systemically important financial institutions (SIFIs)
 - Trading book review
 - Credit ratings and securitizations
 - Cross-border bank resolution scheme
- US regulators have the additional – and challenging – task of harmonizing Basel III and other BCBS actions with Dodd-Frank Act requirements.