

Bank Regulatory Developments in the EU

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Overview

- Capital Requirements:
 - Basel II and Basel III
 - Capital Requirements Directive (including recent and proposed amendments)
 - impact on hybrid capital instruments
 - requirements for SIFIs
- Recovery and Resolution plans:
 - EU
 - UK
- UK Independent Commission on Banking Interim Report:
 - ring fencing of retail banking
 - capital surcharge for SIFIs
- Tax levies:
 - EU
 - UK

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 16 December 2010
- Requirements relating to loss absorbency at point of non viability (“gone concern”) published on 13 January 2011

New Capital Requirements

- Common equity minimum requirement raised gradually to 4.5% of risk weighted assets, phased in in 2013 and 2014
- Overall tier 1 capital requirement raised gradually to 6%, phased in in 2013 and 2014
- Minimum total capital requirement remains at 8%
- New capital conservation buffer of 2.5%, phased in in 2016, 2017 and 2018
- New countercyclical buffer in the range of 0% to 2.5%

New Capital Requirements (cont.)

- Tier 1 capital:
 - common equity
 - non-common equity instruments meeting specific criteria
- Common Equity Tier 1
 - bank's common shares meeting criteria for such classification (or equivalent for non-joint stock companies)
 - stock surplus/share premium on Common Equity Tier 1 instruments
 - retained earnings and other disclosed reserves
 - common shares issued by bank's consolidated subsidiaries and held by third parties (as minority interests) that meet certain additional criteria for inclusion in Common Equity Tier 1 after regulatory adjustments (deductions)

Classification Criteria for Common Equity

- The most subordinated claim in liquidation of the bank
- Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim)
- Principal is perpetual and never repaid outside of liquidation (other than discretionary repurchases or other allowable discretionary capital reductions under relevant law)
- No expectation created at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation
- Distributions paid out of distributable items and not tied or linked to the amount paid in at issuance and not subject to a contractual cap

Classification Criteria for Common Equity (cont.)

- No circumstances under which the distributions are obligatory (no event of default for non-payment)
- Distributions paid only after all legal/contractual obligations have been met (including payments on more senior capital instruments). Therefore no preferential distributions
- It takes the first and proportionately greatest share of any losses as they occur and absorbs losses on a going concern basis proportionately and *pari passu* with all the other instruments within the highest quality capital
- The paid in amount is recognised as equity capital (ie not as a liability) for determining balance sheet insolvency
- The paid in amount is classified as equity under the relevant accounting standards
- It is directly issued and paid-in and the bank can not directly or indirectly have funded the purchase of the instrument

Regulatory adjustments (deductions)

- Deductions from Common Equity Tier 1 include:
 - goodwill/other intangibles (except mortgage servicing rights) (net of associated deferred tax liability)
 - deferred tax assets whose realisation depends on the bank's future profitability (net of associated deferred tax liabilities)
 - treasury stock (unless already de-recognised)
 - certain specified portions of investments in financial institutions not consolidated for regulatory purposes
 - cash flow hedge reserves relating to hedging of items which are not fair valued on the balance sheet
 - any increase in equity capital resulting from securitisation transactions
 - unrealised gains and losses resulting from changes in bank's own credit risk on fair valued liabilities
 - certain other deductions

Additional/hybrid Tier 1 Capital

- To be classified as tier 1 capital, the criteria for non common equity instruments includes:
 - subordinated to all depositors and all creditors
 - not secured or guaranteed
 - perpetual, with no incentives to redeem and no investor put option
 - fully discretionary non-cumulative dividends/coupons
 - callable by bank only after 5 years
 - any return of capital only with prior supervisory authorisation
 - capable of principal loss absorption on a going concern basis, i.e. by a principal write down/conversion to common equity at a trigger point

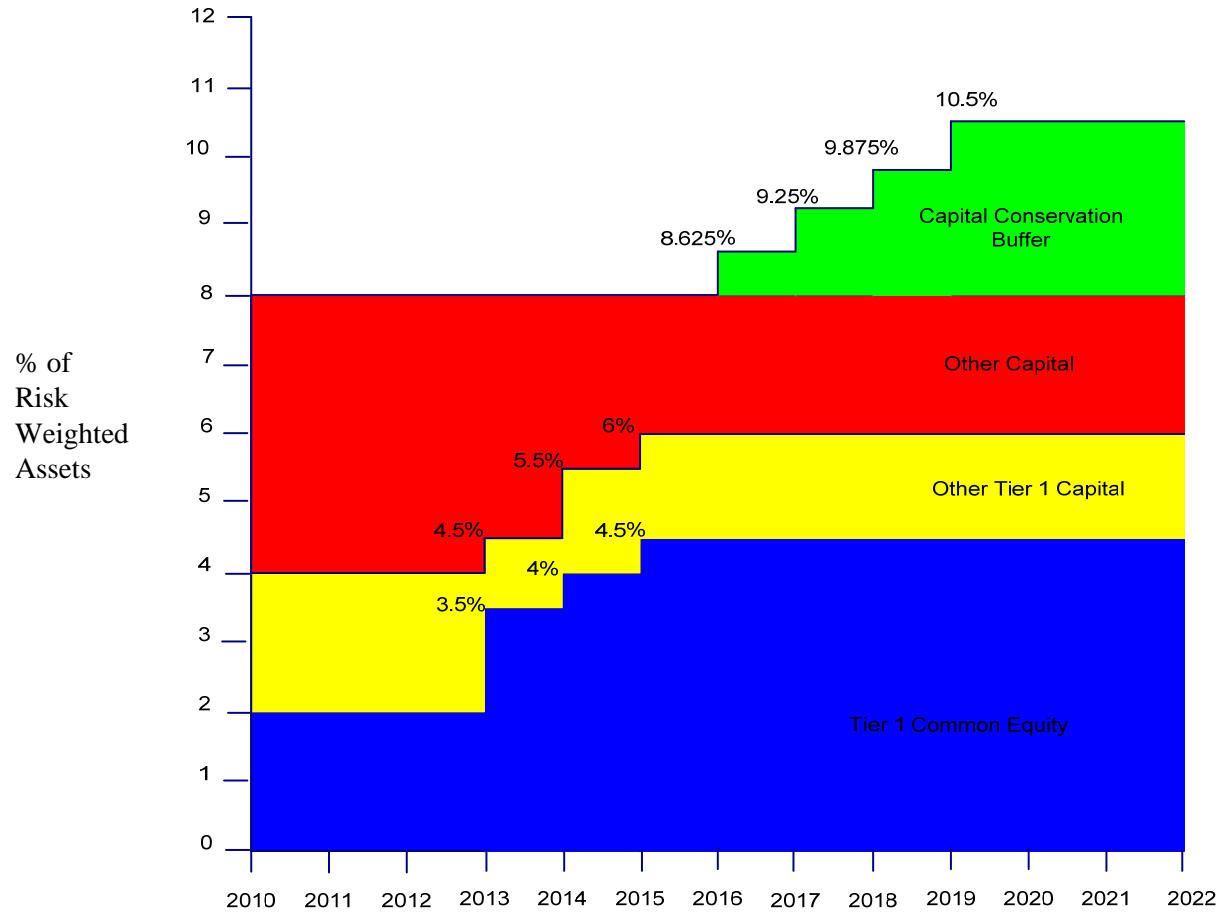
Tier 2 Requirements

- Tier 2 capital to be simplified:
 - elimination of distinction between upper and lower tier 2 (tier 3 to be abolished)
- Minimum Tier 2 criteria:
 - original maturity of at least 5 years, with no incentive to redeem
 - callable only by the issuer and only after 5 years, with prior supervisory approval
 - dividends/coupons – may not have a credit-sensitive dividend feature
 - in a liquidation, subordinated to all non-subordinated creditors

Write-off/conversion

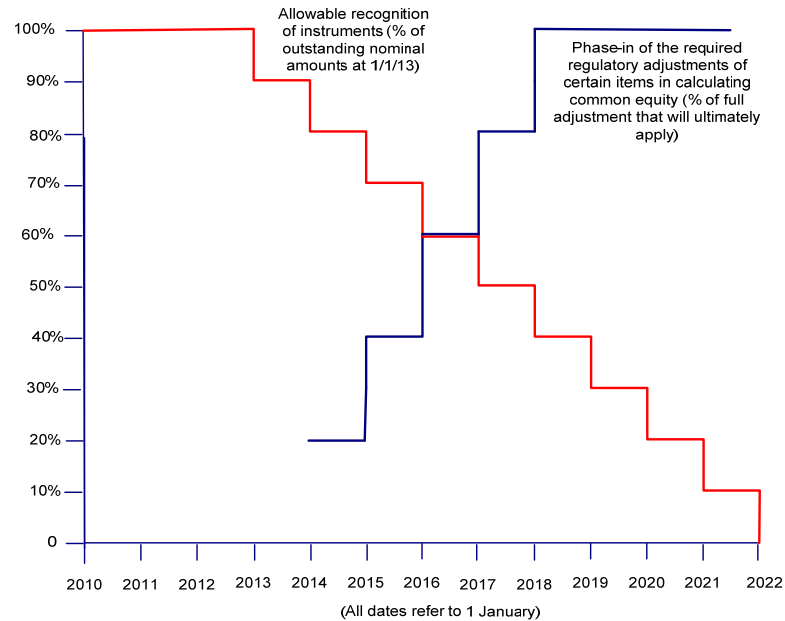
- BCBS consultative document August 2010 and subsequent January 2011 requirements – “gone concern” proposal
- Applies to all tier 1 and tier 2 instruments that are not common stock
- Contractual terms providing for write-off/conversion into common stock upon trigger event occurring
- Trigger event is earlier of:
 - the decision to make a public sector injection of capital without which the bank would have become non viable
 - the decision that a write-off / conversion is necessary, without which the bank would become non-viable
- Additional rules for banking groups
- “Going concern” proposals for contingent capital awaited

Basel III Minimum Capital Requirements



Recognition of (a) Non-common equity instruments (issued before 13 September 2010), that no longer qualify as Tier 1 or Tier 2 capital and (b) Certain non-joint stock company instruments no longer qualifying as Common Equity Tier 1 capital

Capital instruments issued after 12 September 2010 cannot benefit from the phase-out arrangements



Generally, capital instruments no longer meeting the requirements for inclusion in common equity Tier 1 capital will be excluded from common equity Tier 1 from 1 January 2013

Leverage Ratio	Supervisory Monitoring	Parallel Run	Pillar 1
		Disclosure	
Liquidity Coverage Ratio	Observation Period	Minimum Standard In Force	
Net Stable Funding Ratio	Observation Period	Minimum Standard In Force	

Capital Requirements Directive

- CRD-2006
- CRD2
 - hybrid capital
 - securitisation retention/due diligence
 - large exposures
- CRD3
 - resecuritisations and securitisation disclosure
 - trading book treatment
 - executive compensation
- CRD4
 - draft expected July 2011
 - implements Basel III
 - consolidates CRD2 and CRD3 into CRD
 - harmonisation/flexibility issues

Effect of Proposals on Hybrid Capital

- CRD 2 provisions
- Contingent convertibles
- Going concern loss absorption/ bail-in

Capital Conservation Buffer

- To comprise common equity
- Restraints on dividends and discretionary bonuses if buffer falls below 2.5%
- Capital conservation buffer to commence in 2016 at 0.625% and increase to 1.25% in 2017, 1.875% in 2018 and 2.5% in 2019

Countercyclical Buffer

- Primary aim is to protect banking sector from periods of excess credit growth
- Aim is to temper build-up phase of economic cycle
- Each jurisdiction to be given discretion to set countercyclical buffer:
 - will be add-on to minimum buffer range under conservation buffer
 - decisions should be pre-announced by 12 months
- Special rules for internationally active banks
- Banks should calculate the buffer with at least the same frequency as their minimum capital requirements

Leverage Ratio

- Tier 1 leverage ratio to be set at 3% with effect from 2018, following parallel run period between 2013 and 2017
- Current proposal is to base leverage ratio on firm's capital (the numerator) compared to its Exposure (the denominator) on new definition of Tier 1 capital.
- Exposure should follow accounting standards.

Liquidity Ratios

- Two proposed liquidity ratios:
 - short term liquidity cover ratio (“LCR”) from 2015
 - longer-term net stable funding ratio (“NSFR”) from 2018
- Liquidity cover ratio:
 - high quality liquid assets to cover net cash outflows over 30 day period
 - defined as stock of high quality liquid assets divided by total net cash outflows for next 30 days
- Net stable funding ratio:
 - designed to promote resilience over a period of one year
 - available stable funding (“ASF”) must be at least equal to required stable funding (“RSF”)

BCBS Proposals Still Awaited

- Going-concern proposals
- Systemically important banks
- Cross-border bank resolution

G-20 – Systemically Important Financial Institutions

- G-20 meeting in Seoul endorsed FSB’s proposals to reduce “moral hazard risks” posed by SIFIs and address the “too big to fail” issue
- SIFIs should have loss absorbency capital commensurate with system-wide losses that would be occasioned by their failure
- Initial focus on global SIFIs (GSIFIs):
 - FSB and national authorities to draw up list of GSIFIs by mid 2011
- GSIFIs to be required to have greater capacity to absorb losses than under proposed Basel III minimum standards
- More intensive and effective supervisory oversight

G-20 – Systemically Important Financial Institutions (cont.)

- Resolution Frameworks:
 - all jurisdictions should have a resolution framework in place to facilitate rapid resolution of a failing institution
 - depositors should be able to continue to access their deposits
 - authorities must have power to transfer and sell viable parts of the entity
- Internationally active institutions:
 - sharing and co-operation agreements
 - elimination of laws protecting domestic creditors at expense of foreign creditors
 - for GSIFIs, co-operation agreement between home and host authorities
- FSB to draw up criteria for assessing resolvability of SIFIs by mid-2011
- Ongoing work throughout 2011 FSB/Basel Committee on cross-border crisis management, bail-in and supervisory tools

Recovery and Resolution Plans – EU Commission Consultation

- EU Commission Communication re EU framework for crisis management in the financial sector – October 2010
- EU Commission technical details of a possible framework for bank resolution and recovery – January 2011 consultation paper:
 - supervision, preparation and prevention
 - early intervention
 - resolution tools
 - framework for co-operation between national authorities
- Legislative proposal expected later in 2011:
 - interaction with Basel and FSB work on SIFIs

Recovery and Resolution Plans – EU Commission Consultation (cont.)

- Scope
 - all credit institutions
 - certain investment firms
 - EU holding companies of credit institutions/other financial companies
- Each member state to identify “resolution authority” to exercise resolution powers
- European Banking Agency (**EBA**) to have role in supervision of proposed framework and development and co-ordination of recovery and resolution plans

Recovery and Resolution Plans – EU Commission Consultation (cont.)

- Enhanced supervision of credit institutions
- Firms must develop recovery plans:
 - aimed at restoring the long term viability of the entity in times of financial difficulty
- Firms must also develop resolution plan for when entity fails and there is no realistic prospect of recovery:
 - plan should cover variety of issues including options in different stress scenarios, financing, critical functions and continuity plans
 - information to be provided to resolution authorities
- Authorities to have powers to require banks to take measures to remove impediments to effective resolution planning

Recovery and Resolution Plans – EU Commission Consultation (cont.)

- Additional early intervention powers proposed including:
 - requiring institution to raise additional own funds
 - prohibiting payment of dividends
 - requiring replacement of managers or directors
 - changing certain activities / business lines
 - requiring implementation of recovery plan
- Power to appoint special manager for limited period

Recovery and Resolution Plans – EU Commission Consultation (cont.)

- Resolution tools and powers:
 - to be used when no realistic prospect of recovery and all other measures exhausted
- 3 alternative trigger options:
 - solvency test
 - regulatory authorization test
 - regulatory capital test
- Authorities should have regard to “resolution objectives”:
 - ensuring continuity of essential financial services
 - avoiding adverse effects on financial stability
 - protecting public funds
 - protecting insured depositors

Recovery and Resolution Plans – EU Commission Consultation (cont.)

- Principles of resolution tools and powers include:
 - shareholders should first bear losses
 - creditors of same class treated in fair and equitable manner
 - no creditor should incur greater losses than under a liquidation
- Resolution tools include:
 - sale of business tool – no need for shareholder consent
 - bridge bank tool – temporary measure
 - asset separation tool – moral hazard concerns
 - debt write down / conversion tool (bail-in provisions)
 - safeguards for partial property transfers
- Two possible approaches to bail-in considered:
 - authorities to have broad powers to write off or convert into equity all senior debt, subject to certain exemptions
 - requirement on banks to issue a fixed volume of “bail-in” debt

Recovery and Resolution Plans – EU Commission Consultation (cont.)

- Consultation and co-operation between authorities in absence of harmonized insolvency regime and single EU supervisory authority
- “Resolution colleges” for cross-border banks
- Member states required to establish bank resolution fund

Recovery and Resolution Plans – UK Position

- UK has already taken steps to introduce recovery and resolution regimes:
 - Banking Act 2009
 - Financial Services Act 2010
- Banking Act 2009 – special resolution regime:
 - private sector rescue of bank
 - state controlled bridge bank as temporary measure
 - full public temporary ownership
- Financial Services Act 2010 will give FSA powers to require banks to produce “living wills”
- FSA to publish proposals shortly

Recovery and Resolution Plans – Other International Initiatives

- Basel Committee / Financial Stability work on SIFIs
- UK ICB Report
- United States:
 - Dodd-Frank Act
 - Title I – Financial Stability Act and Living Wills
 - Title II – Orderly Liquidation Authority

UK ICB Interim Report - Overview

- Interim report published 11 April 2011
- Final report to be published in 12 September 2011
- Findings not binding on UK government but most recommendations are expected to be implemented
- Areas covered by report include:
 - bank stability including capital, equity and surcharge for SIFIs
 - structural reform
 - competitiveness

UK ICB Interim Report – Bank Stability

- Increasing loss-absorbency capacity:
 - SIFIs
 - equity
 - debt, including contingent capital and bail-in debt
 - depositor preference
- Surcharge for SIFIs:
 - recommended at 3% (on top of Basel III 7% minimum for common equity)
 - UK banks should not be required to hold more than international minimum
 - large UK retail banking operations should however be backed by common equity ratio of at least 10%

UK ICB Interim Report – Bank Stability (cont.)

- Contingent capital
- Bail-in debt:
 - need for international agreement
- Depositor preference:
 - proposed priority for deposits
 - question as to whether such a preference should be limited to deposits guaranteed by the Financial Services Compensation Scheme

UK ICB Interim Report – Structural Reform

- Retail ring fence:
 - minimum capital ratios for UK retail banking operations
 - constraints on movement of capital away from ring-fence
 - consideration of activities and assets falling in retail ring-fence
 - holding of equity in other group companies
- Geographic scope of retail ring-fence
- Implication against incoming branches of other EU banks

UK ICB Interim Report – Structural Reform (cont.)

- Other possible types of separation considered but not recommended included:
 - full segregation
 - operational segregation
 - Volcker rule equivalent
 - other forms of subsidiarisation
 - narrow banking
 - full reserve banking
 - size limits
 - payment systems

UK ICB Interim Report – Competitiveness

- UK financial sector is large relative to GDP and concentrated in a small number of institutions:
 - need for orderly resolution of failing institutions and reducing levels of risk in the financial system as a whole
- Measures proposed to improve competition in UK retail banking industry include:
 - further divestiture of assets by Lloyds banking group
 - improvement of conditions for consumer choice in banking sector including making it easier for customers to switch bank accounts
 - giving the Financial Conduct Authority a primary duty to promote competition

Bank Levies - UK

- UK June 2010 budget – government announces introduction of bank levy from 1 January 2011:
 - aimed at encouraging banks to move away from riskier lending
 - consultation process between July and October 2010
- Finance Bill 2011 published in March 2011 set out revised bank levy legislation:
 - revised version published on 13 June 2011
- Levy is chargeable on consolidated balance sheets of UK banks and building societies:
 - for foreign banking groups, charged on aggregated balance sheets of UK sub-groups and subsidiaries
 - also chargeable for non-banking groups on balance sheets of UK banks and banking sub-groups

Bank Levies – UK (cont.)

- Levy based on chargeable equity and liabilities with various exclusions including:
 - FSCS liabilities
 - tier 1 capital
 - certain protected deposits
- Liabilities may be reduced under netting rules and in relation to certain high quality liquid assets
- Levy is on chargeable equity and liabilities to the extent they exceed £20bn
- Levy rate is now:
 - 0.078% for short term liabilities
 - 0.039% for long term equity and liabilities
- Rates differ slightly for 2011

Bank Levies - EU

- EU Commission consultation in October 2010:
 - considered either a financial activities tax or financial transactions tax
 - consultation ended in April 2011
- In March 2011 European Parliament adopted (non-binding) resolution approving a tax on financial transactions:
 - proposed tax of between 0.01 and 0.05% on all financial transactions at EU level
 - estimated to raise €200 billion each year
- EU Commission expected to publish proposals following its consultation