

UPDATE ON BASEL III REQUIREMENTS

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Outline

- Basel III proposals
 - new capital requirements
 - effect of proposals on hybrid capital
 - capital conservation ratio
 - countercyclical buffer
 - leverage ratio
 - liquidity ratios
- Further proposals awaited
- Systemically important financial institutions

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 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 Shares

- 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 Shares (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 3 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

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

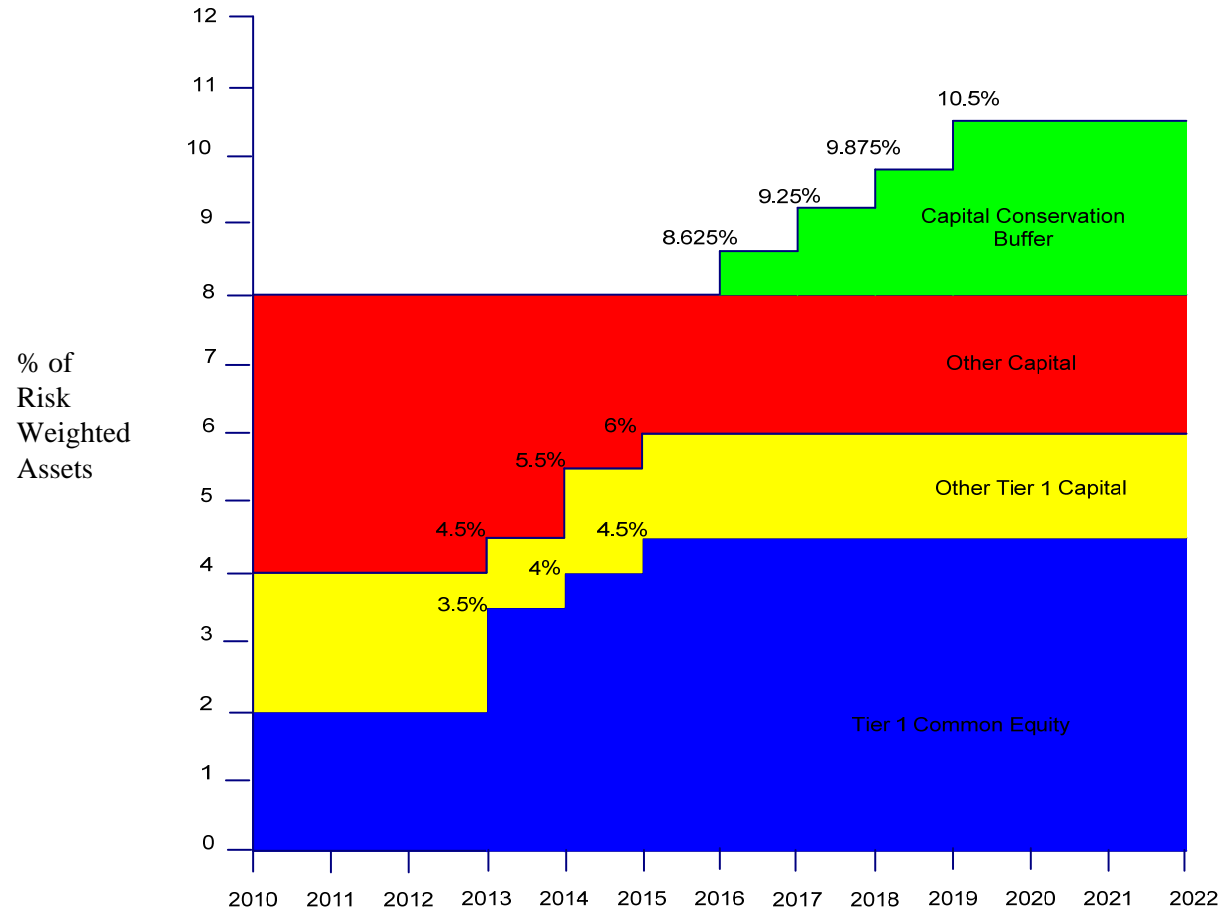
Write-off/conversion

- BCBS consultative document August 2010 – “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

Phase-In of New Capital Requirements

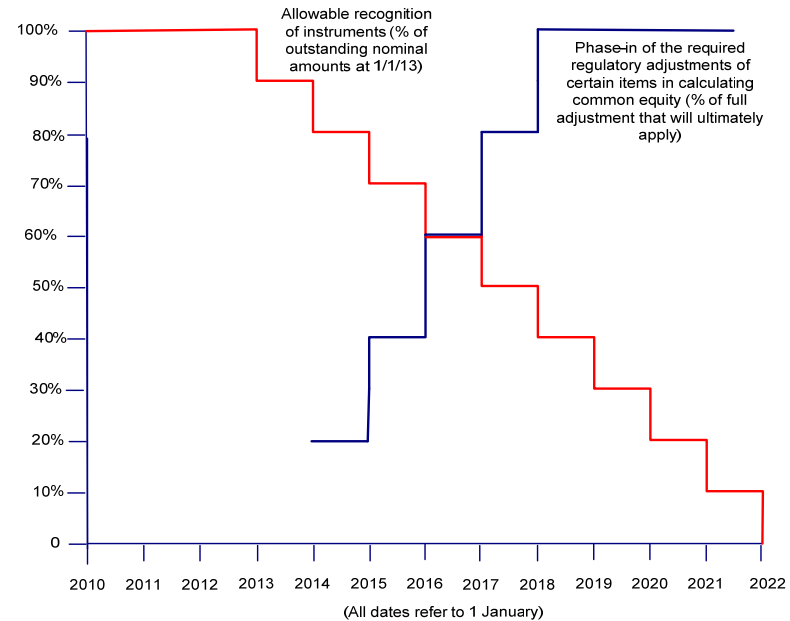
- Minimum common equity and tier 1 requirements to be phased in between 1 January 2013 and 1 January 2015:
 - common equity tier 1 minimum raised to 3.5% in 2013, 4% in 2014 and 4.5% in 2015
 - total Tier 1 capital to be raised to 4.5% in 2013, 5.5% in 2014 and 6% in 2015
- Regulatory adjustments to be phased in from 1 January 2014:
 - initially to be 20% of deduction increasing to 100% by 2018
- Grandfathering of existing instruments:
 - existing capital instruments that no longer qualify as tier 1 or tier 2 capital will be gradually derecognised from 1 January 2013 over 10 years
 - capital no longer qualifying as common equity will be excluded from 1 January 2013 with gradual de-recognition in limited circumstances

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

Effect of Proposals on Hybrid Capital

- CRD 2 provisions
- Dodd-Frank provisions
- Tier 1 v tier 2
- Current activity:
 - contingent convertibles
 - principal write downs
 - step down, step-up structures

Capital Conservation Ratio

- To comprise common equity
- Restraints on dividends and discretionary bonuses if buffer falls below 2.5%
- Capital conservation ratio 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

Countercyclical Buffer (cont.)

- EU Consultation Paper – September 2010
- ESB and ESRB to develop principles and technical standards in relation to calculation of buffer add-ons
- Competent authorities to set buffer add-ons
- Add-ons subject to 2.5% ceiling

Leverage Ratio

- Tier 1 leverage ratio to be set at 3% during parallel run period between 2013 and 2017
- Bank level disclosure of leverage ratio and components to start in January 2015
- Supervisory monitoring period to commence on 1 January 2011
- Leverage ratio not to become binding until early 2018
- Current proposals is to base leverage ratio on banks' capital (the numerator) compared to their Exposure (the denominator) on new definition of tier 1 capital.
- Exposure should follow accounting standards.

Leverage Ratio (cont.)

- High quality liquid assets include cash and cash-like instruments in the measure of Exposure
- Securitisation exposures will be counted in a manner generally consistent with accounting treatment
- Derivatives exposures will either follow the applicable accounting treatment or use the current exposure method
- Other off balance sheets are included:
 - commitments
 - unconditionally cancellable commitments
 - direct credit substitutes
- 10% credit conversion factor for any commitments that are unconditionally cancellable at any time by the bank.

Counterparty Credit Risk (“CCR”) Framework

- Basel III makes significant changes to CCR framework with effect from 2013.
- Measures designed to strengthen risk coverage include:
 - expected positive exposure with stressed parameters to address wrong-way risk
 - 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)
 - higher capital charges for bilateral OTC exposures to financial institutions

Counterparty Credit Risk (“CCR”) Framework (cont.)

- Banks to determine capital charges for CCR using stressed inputs.
- 1.25 asset value correlation multiplier to large regulated financial institutions whose total assets are at least U.S.\$100bn
- Central counterparties:
 - ongoing IOSCO work
 - standards to be finalised during 2011
 - BCBS consultative document relating to capitalisation of exposures to CCPs

External Credit Ratings

- BCBS believe aspects of existing capital framework encouraged investors to place too much reliance on external credit ratings
- 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
 - banks should use ratings of CRAs consistently for both risk weighting and risk management purposes

Liquidity Ratios

- Two proposed liquidity ratios:
 - short term liquidity cover ratio (“LCR”)
 - longer-term net stable funding ratio (“NSFR”)
- Liquidity cover ratio:
 - high quality liquid assts 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

Liquidity Ratios (cont.)

- Certain high quality liquid assets (“level 1 assets”) to be included on asset side on an unlimited undiscounted basis
- Level 2 assets must comprise no more than 40% of the overall stock and must have a minimum 15% haircut
- Observation period for liquidity cover 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 1 January 2018

BCBS Proposals Still Awaited

- Going-concern proposals
- Systemically important banks
- Trading book review
- Credit ratings and securitisations
- 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 March 2011