

UPDATE ON BANKING REGULATION IN THE UK AND EU

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Outline

- Capital and liquidity – Basel III and CRD amendments
- Living wills
- UK Special Administration Regime for investment banks
- Changes to regulatory supervisory framework:
 - 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
- Text of Basel III rules to be published by end 2010

New Capital Requirements

- Common equity minimum requirement raised to 4.5% of risk weighted assets
- Overall tier 1 capital requirement raised to 6%
- Minimum total capital requirements remains at 8%
- New capital conservation buffer of 2.5%
- New countercyclical buffer in the range of 0% to 2.5%
- Leverage ratio – 3%

New Capital Requirements (cont.)

- Tier 1 capital:
 - common equity (common shares and retained earnings)
 - non-common equity meeting specific criteria
- To be classified as tier 1 capital, the criteria for non common equity includes:
 - subordinated
 - not secured or guaranteed
 - no incentives to redeem
 - fully discretionary non-cumulative dividends
 - payment of principal only with prior supervisory authorisation
 - capable of principal loss absorption

New Capital Requirements (cont.)

- Tier 1 regulatory adjustments:
 - stock surplus
 - minority interests
 - goodwill and other intangibles
 - investments in other financial institutions
 - intangible assets
 - significant investments (more than 10%) in common shares of unconsolidated financial institutions
- Rules relating to counterparty credit risk (“ccr”) arising from derivatives, repos and securities financing activities

Capital Requirements (cont.)

- Tier 2 capital to be simplified:
 - elimination of distinction between upper and lower tier 2
 - to meet similar criteria to tier 1 non common equity capital
 - original maturity of at least 5 years with no incentive to redeem
 - no right for investor to accelerate principal or interest save in an insolvent liquidation
- Tier 3 capital to be abolished

New Capital Requirements (cont.)

- BCBS consultative document August 2010 – “gone concern” proposal
- Applies to all tier 1 and tier 2 instruments that are not common stock
- 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

New Capital Requirements (cont.)

- 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

Effect of Proposals on Hybrid Capital

- CRD 2 provisions
- Effect of Basel III and gone-concern consultation
- 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

- BCBS consultation paper – 16 July 2010
- 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 new definition of tier 1 capital.

Liquidity Ratios

- BCBS in December 2009 set out two proposed liquidity ratios:
 - short term liquidity cover ratio
 - longer-term net stable funding ratio
- July 2010 Annex made significant changes to proposals
- Short term liquidity cover ratio:
 - high quality liquid assets to cover net cash outflows over 30 day period
 - definition of liquid assets widened by July 2010 Annex
- Net stable funding ratio:
 - focus on longer term stable sources of funding (at least one year)
 - more work to be done on determining calculation of ratio

Liquidity Ratios (cont.)

- Observation period for liquidity cover ratio commence in 2011 and ratio to be introduced at start of 2015
- Net-stable funding ratio to be introduced in 2018
- UK FSA October 2009 rules

BCBS Proposals Still Awaited

- Going-concern proposals
- Trading book review
- Credit ratings and securitisations
- Systematically important banks
- Cross-border bank resolution

G-20 – Systematically 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 – Systematically 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

Recovery and Resolution Plans ("LIVING WILLS")

- Detailed plans by financial institutions to (a) try and ensure the institution's survival in times of financial stress and (b) wind down their operations in an insolvency scenario
- Designed to supplement the regulatory resolution regimes, such as SRR in the UK, introduced by Banking Act 2009
- Integral factor in FSA's assessment of prudential risk

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UK and EU Timeline

- In UK, Financial Services Act 2010 granted rulemaking powers to FSA
- FSA Consultation Paper due in December 2010
- In EU, European Commission Communication in October 2010
- Draft Legislation in spring 2011

Contents of the Living Will

- Recovery
 - how to restructure/ reorganise to try and ensure survival
- Resolution
 - how to ensure the failure of the firm in a controlled manner, limiting disruption

Recovery

- Recovery plan will include action the firm would take in, or prior to the onset of, stressed financial circumstances, which could consist of:
 - restructuring
 - scaling back or hiving off certain businesses/assets/liabilities
 - changes to funding profile
- Example in relation to Northern Rock:
 - addressing funding reliance on securitisation
 - addressing its other business model limitations e.g. squeezing net interest margin
 - encumbrance of high quality assets for securitisation master trust

Resolution

- Resolution plan would cover action to be taken both
 - in event of firm's failure
 - where firm's failure is likely
- Would include action to be taken by the authorities pursuant to their SRR powers and may require a firm to identify any impediments to a resolution

Fantasy LBIE Resolution Plan

- Speech of Andrew Bailey of Bank of England, November 2009
- Resolution plan of LBIE should have included:
 - up-to-date, detailed balance sheet for all group entities
 - mapping of inter-affiliate dependencies
 - wind-down plans for all business areas
 - contact plan for major stakeholders
- Changes to LBIE corporate structure should have included
 - corporate entity-based accounts
 - segregation of client asset-handling activities
 - controls over depositing client money with affiliates

Investment Banks – Special Administration Regime

- Background – Lehmans
- Issues included differentiating client assets from “house” assets, valuing liabilities and recovering intermediated assets and practical difficulties such as reconciling books and records in a large, complex institution
- Interpreting the interplay between different cross-product master agreements
- Understanding complex intra-group arrangements

SAR for Investment Banks

- Banking Act 2009
- SRR, Bank Insolvency Regime, Bank Administration Regime don't apply to non-deposit taking firms
- HMT still considering an SRR targeted at investment banks
- Powers under section 233 to HMT to prescribe investment bank insolvency regulation
- Draft Investment Bank Special Administration Regulations 2011 published by HMT in September 2010

SAR for Investment Banks (cont.)

- “Investment Bank” means a UK institution that
 - is permitted to carry out any of the regulated activities of (a) safeguarding and administering investments, (b) dealing in investments as principal or (c) dealing in investments as agent, and
 - holds client assets – “assets which an institution has undertaken to hold for a client (whether or not on trust and whether or not the undertaking has been complied with)”
- HMT proposes an amendment to the definition of client assets
 - to make it clear that it includes client money, and
 - to clarify that it only means assets over which the client intended to remain able to exert a proprietary claim

SAR Key Features

- Based on administration procedures contained in Insolvency Act 1986 relating to corporates
- 3 revised objectives
 - return of client assets as soon as practicable
 - prompt engagement with market infrastructure bodies and tripartite authorities
 - either rescue of firm as a going concern or a winding up if in the best of interests of creditors
- Administrator can set a bar date for claims to client assets
- Can allocate shortfalls in client assets held in omnibus accounts on a pro rata basis

SAR Key Features (cont.)

- Key supplies and services to the firm must continue uninterrupted so the providers may not terminate the supplies/services until the administrators have made alternative arrangements
 - IT services
 - computer software used for securities trading
 - broadband/e-mail
 - commercial banking services
- Administrator liability
- Deposit – taking firms

New European Financial Supervisory Framework

- European Systemic Risk Board
- European System of Financial Supervisors
- European Banking Authority, to replace CEBS
- European Securities and Markets Authority, to replace CESR
- European Insurance and Occupational Pensions Authority, to replace CEIOPS

Functions and Powers of new ESAs

- Policy coordination/ Rule-setting
- Co-ordination of supervision of individual firms
- Monitoring and enforcement
- Binding mediation
- Power to restrict/ ban
- Power to investigate

Functions and Powers of new ESAs (cont.)

- Generally no direct supervisory responsibilities (except for rating agencies)
- Joint committee of ESAs to be formed to co-operate and ensure cross-sectoral consistency on certain matters
 - financial conglomerates
 - accounting/ auditing
 - retail investment products
 - anti-money laundering

Amendments to UK Regulatory Structure

- Mansion House Speech June 2010
- HMT consultation paper July 2010
- HMT consultation and November 2010 announcement
- New regulatory bodies:
 - Financial Policy Committee of the Bank of England (“FPC”)
 - Prudential Regulation Authority (“PRA”)
 - Consumer Protection and Markets Authority (“CPMA”)
- Proposals to establish a separate economic Crime Agency have been shelved

Amendments to UK Regulatory Structure (cont.)

- UKLA to be transferred to CPMA
- Co-operation between FPC, PRA and CPMA
- Co-ordination with new EU bodies
- Core statutory objectives
- Further work includes:
 - HMT and BIS to produce joint consultation on consumer credit regulation
 - interim FPC to be established in BoE
 - consultation on detailed proposals and draft legislation to be published early 2011

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