

Basel III

What is it?

How will it concern you?

Agenda

Basel III – Why?

Summary of all key changes

Capital aspects

Liquidity aspects

IT & operational impacts

How PwC can help

The regulators' intent with Basel III is a future of more capital, more liquidity, and lower risk.

Basel III – A serious impact at many levels

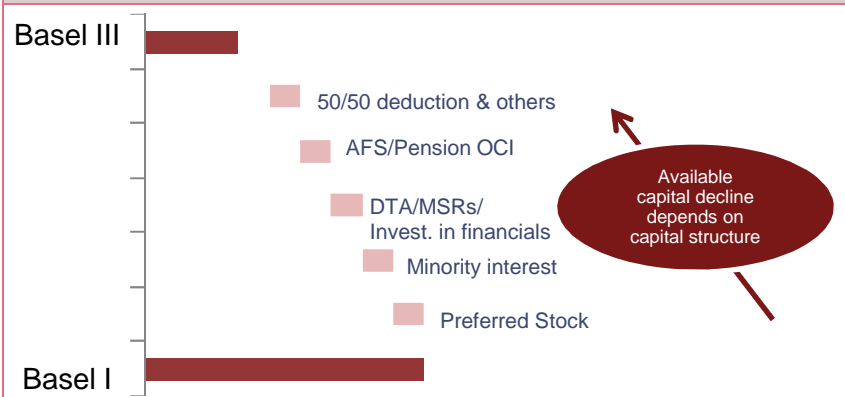
Basel III establishes **tougher capital standards** through more restrictive capital definitions, higher risk-weighted assets (RWA), additional capital buffers, and higher requirements for minimum capital ratios. It also introduces new strict **liquidity requirements**.

The reforms will fundamentally **impact profitability and require transformation** of the business models of many banks.

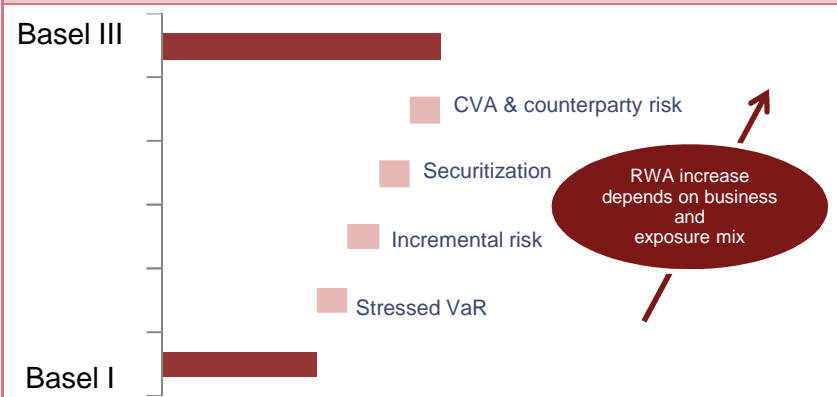
These reforms will also require banks to undertake **significant process and system changes to achieve upgrades**, particularly in the areas of stress testing, liquidity and capital management infrastructure.

Basel III will result in less available capital to cover higher RWA requirements and more stringent minimum coverage levels.

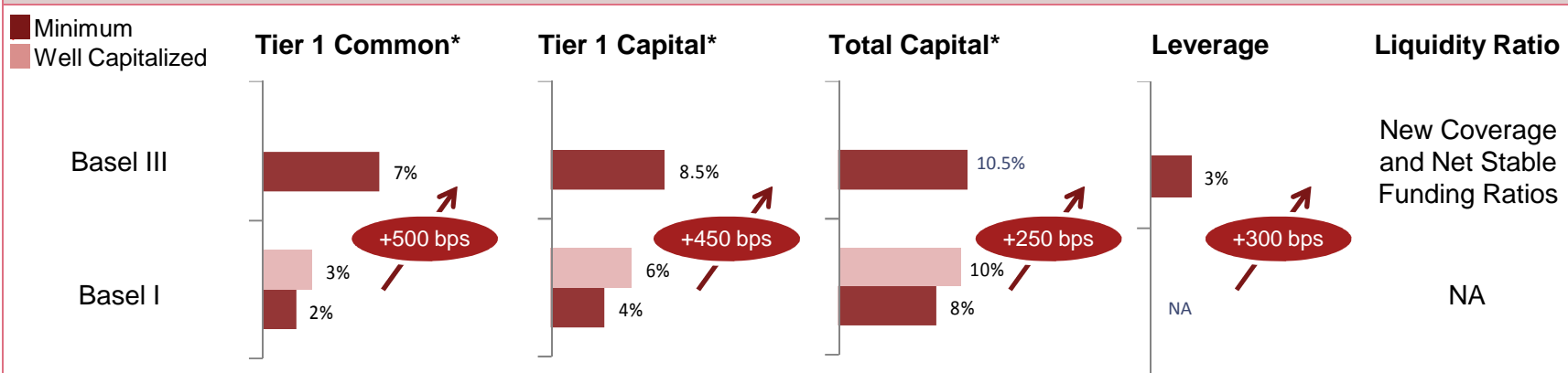
Less available capital through stricter definition of capital with greater deductions that emphasize stronger quality



Higher RWA requirements to better capture risks related to trading, securitization, and counterparty exposures



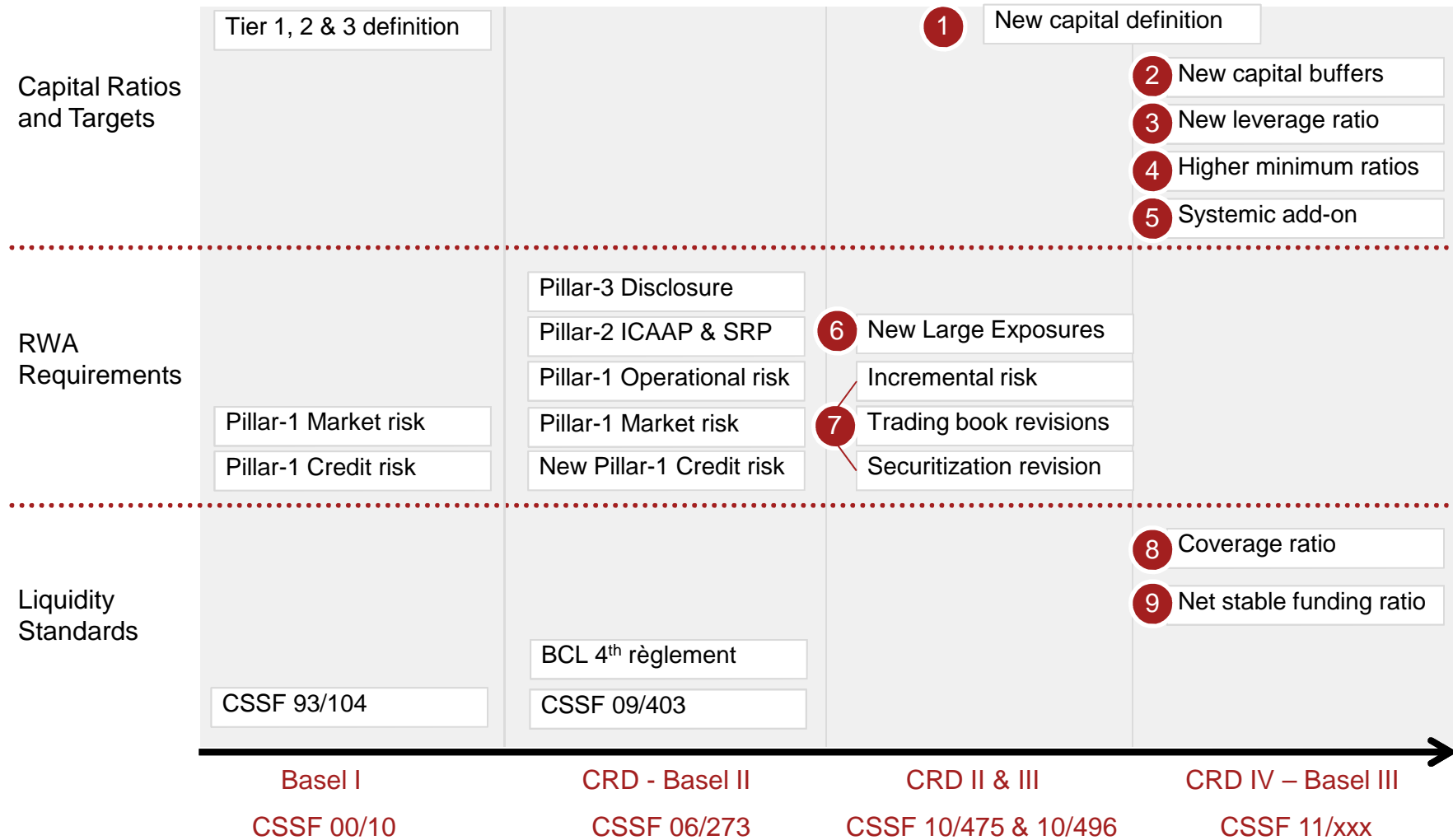
Significant increases in minimum required levels of capital and liquidity



* Includes conservation buffer, but does not include a 0%–2.5% countercyclical buffer.

An overview of Basel III—Introduction

Key changes brought about by Basel I, II, and III and equivalent Luxembourg regulation



1	New capital definition
2	New capital Buffers
3	New leverage ratio
4	Higher minimum ratios
5	Systemic add-on
6	New Large Exposures
7	Trading Book and Securitisation
8	Coverage Ratio
9	Net Stable Funding Ratio

Quality, Consistency and Transparency of Capital

1 Capital Definition

Three main areas of focus:

- Revision of the regulatory **capital structure**:
 - a) Tier 1 – **going concern** capital:
 - Core Tier 1 – common equity, and
 - Non-core Tier 1 – hybrid capital (strict eligibility criteria)
 - b) Tier 2 – **gone concern** capital
 - c) Tier 3 – **abrogated**

- Harmonisation of regulatory **capital deductions** (holdings in financial subsidiaries, Deferred Tax Assets, etc.) and their treatment across territories: progressive full deduction of Core Tier 1

- Publication of detailed **disclosures** of regulatory capital elements and adjustments

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New capital buffers

2 Capital Conservation Buffer

Save for a rainy day

- Create **buffers in 'good times'** that can absorb shocks in periods of stress (includes capital distribution constraints when capital levels fall within a specified range above minimum requirements)
- **Impose good bank governance** by increasing regulators' power (e.g. limit ability of banks to pay high dividends or bonuses in case of hard times)

2 Countercyclical Buffers

Prevent excessive credit growth

- **Macro-prudential buffer** add-on to the capital conservation buffer designed to protect the banking sector from period of **excess credit growth**
- Will be **country-dependent**, i.e. function of where the bank has exposures to the private sector

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New non-risk based limits

3 New leverage ratio

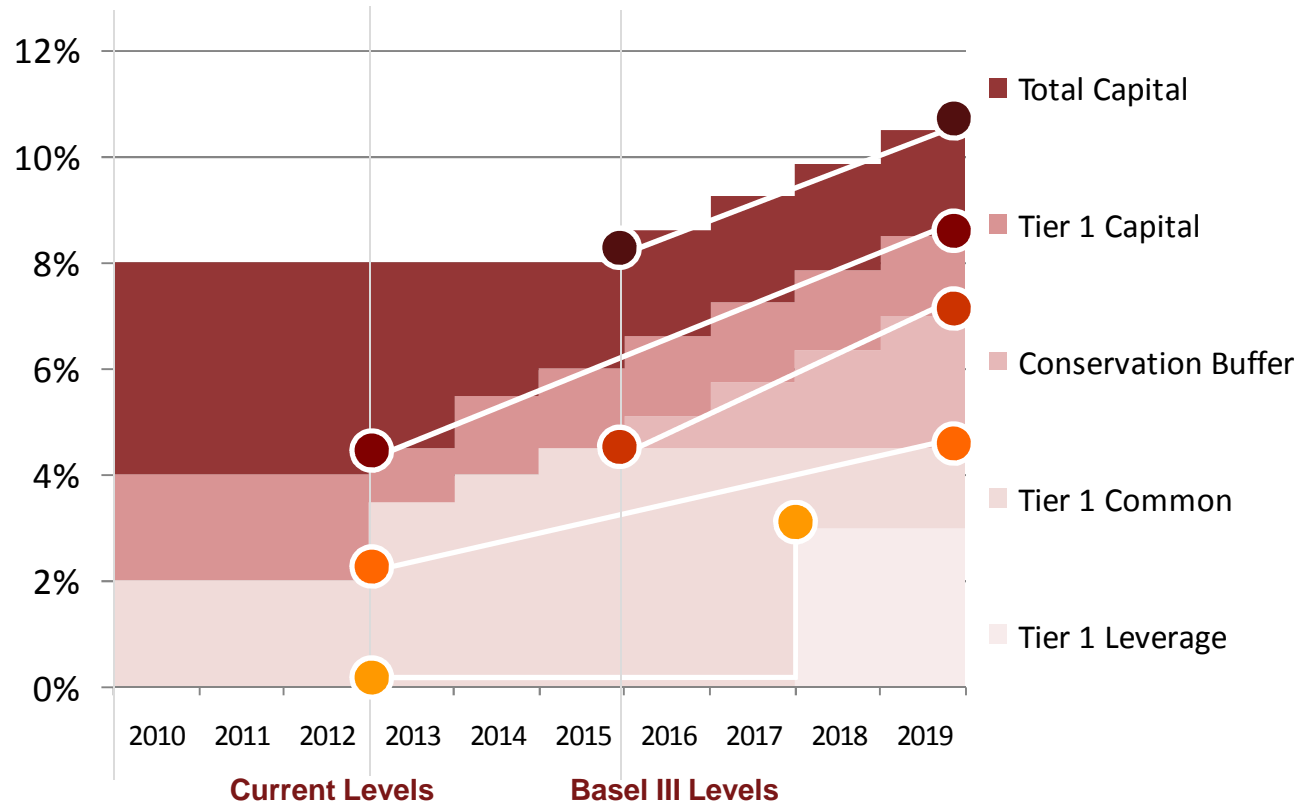
Know your own limits

- Simple and transparent ratio designed to **put a cap on the build-up of leverage** in the banking sector as well as to introduce additional **safeguards against model risk and measurement errors**
- **Volume-based ratio, not risk adjusted**, to complement the risk-based minimum capital requirements under Pillar 1:
 - Total Tier 1 Capital / Total (on- and off-balance sheet) exposures
- Credit Conversion Factor of **10%** applies to unconditionally cancellable **commitments** (whereas 0% for solvency ratio)!
- The Committee is proposing to test a **3% Tier 1** leverage ratio
- Supervisory **monitoring starts in 2011!** Migrates to Pillar 1 in 2018

Capital Ratios and Targets

4 Minimum Capital Standards

- 1 New capital definition
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Minimum Ratios		Transition Period
Current	Basel III	
8%-10%	10.5%	2016-2019
4%-6%	8.5%	2013-2019
NA	2.5%	2016-2019
2%-3%	7%	2013-2019
NA	3%	2013-2018

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Systemically important banks

5 Systemic add-on

Be responsible

- Development of policy options designed to reduce risks related to the **failure of systemically relevant, cross-border institutions**
- Includes possible introduction of a **capital and/or liquidity surcharge** for these institutions, contingent capital or bail-in debt. Work is also continuing on resolution regimes (**‘living will’**)
- Consultation period and more **detailed proposals yet to be issued**
- Impact **unclear at Luxembourg level** – will it also impact subsidiaries of systematically important banks?

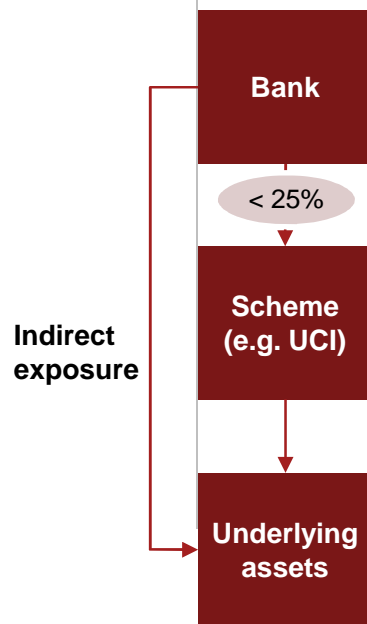
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Concentration risk

6 New Large Exposures regime

Don't put all your eggs in the same basket

- CSSF Circular 10/475. In force **31 December 2010**
- Introduces very significant restrictions



- **Exposures on institutions**
- Stricter definitions of **connected clients**: Need to set-up a robust process to identify connected clients for all exposures that exceed 2% of own funds
- Notion of **economic interconnection** enlarged
- **Exposure to schemes** (UCIs, securitization). Look through incentive: All unknown exposures from schemes should be considered as belonging to one single group of connected clients

- Large exposures to be reported in **new COREP** by Dec 31, 2012

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New Risk-Weighted Asset (RWA) requirements

7 Trading Book and Securitization

Revision of a 1996 rule

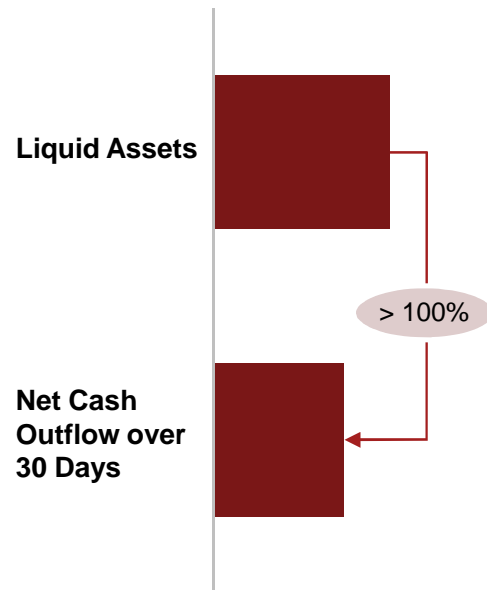
- Higher capital requirements to capture the credit **risk of complex trading activities** and include a stressed value-at-risk (SVaR)
- Introduction of an **Incremental Risk Charge** (IRC) to account for liquidity risk and credit migration risk in the credit trading book
- Higher risk weights for **re-securitisation exposures**
- Higher capital requirements for **OTC derivatives**: incentive to move to centralised clearing

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New Liquidity Requirements

8 Liquidity Coverage Ratio

Stay afloat – Weather the storm



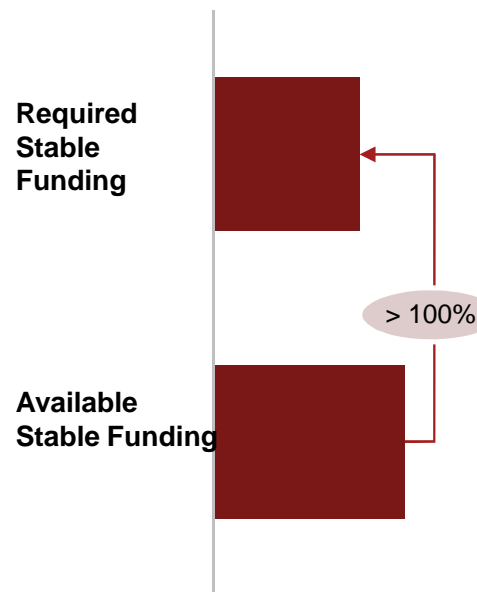
- For many institutions, the **liquidity challenge is likely to be greater** than the capital challenge.
- Objective: Ensure that a bank maintains an adequate level of high-quality, unencumbered assets to enable it to **weather a severe stress scenario** specified by supervisors
- Short-end of a bank's counterbalancing capacity
- Net cash outflows calculated according to **strict parameters specified by supervisors**
- **Stock of highly liquid assets** subject to quantitative and qualitative eligibility criteria

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New Liquidity Requirements

9 Net Stable Funding Ratio

You are in it for the long run



- Objective: Provide **incentive for structural changes** to shift from short-term funding profiles to more stable, **longer term funding** profiles and reduce reliance on wholesale funding
- Medium- to long-term orientation
- Assets (on- and off-balance sheet) are assigned required stable funding factors
- Liabilities are assigned available stable funding factors

Likely IT and Operational Impacts

Systems Impacts

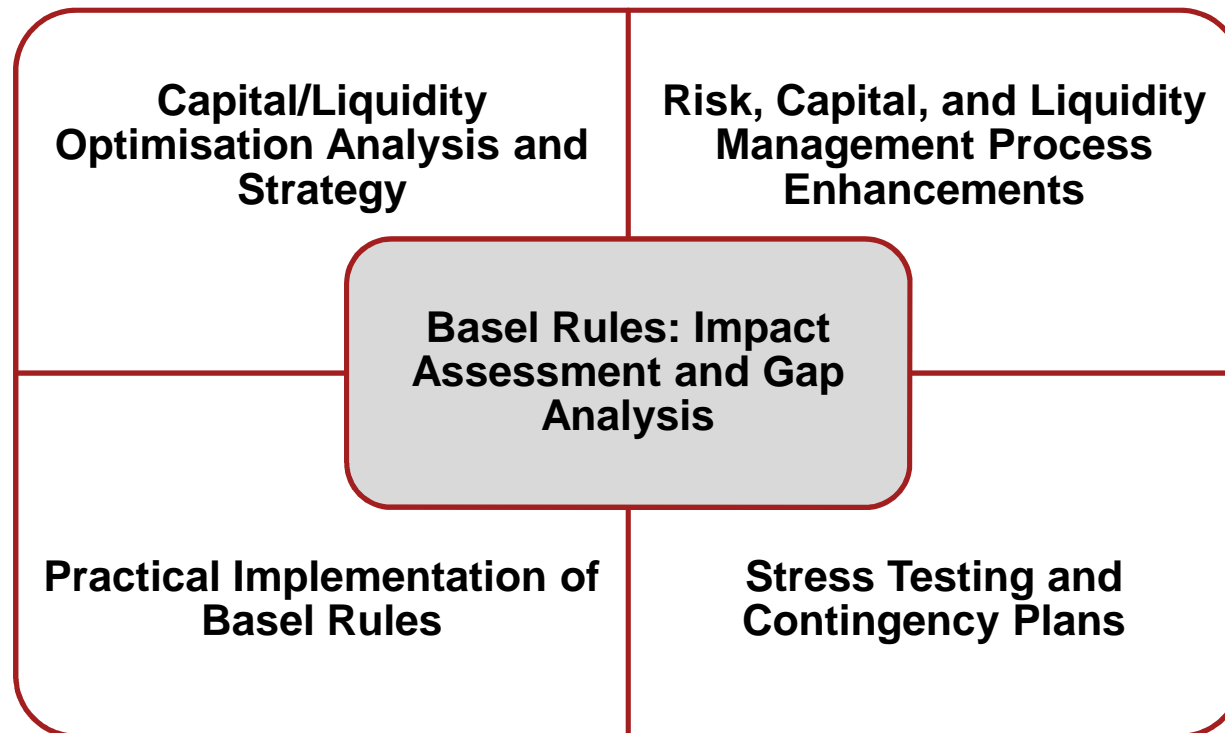
- **Liquidity risk:** Use of SWIFT messages for intraday liquidity monitoring, granularity required for NSFR computation & forecasting needs a very significant boost
 - **Inter-connectivity:** Accounting information, client-data and risk systems need to be interconnected ever more (Large Exposures, Leverage Ratio, stress-testing, ...)
 - **Flexible processes and infrastructures** that may be amended and fine-tuned as new reporting requirements arise
 - **Automation:** Best-of-class already have ability to reconcile data, compute ratios and check limits on a daily basis
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Operational Impacts

- **New processes** and procedures to comply with new functionalities
 - **New reporting & disclosures** that require the implementation of additional processes and controls
 - **Rationalisation:** Basel III may be a unique opportunity to streamline various reports and disclosures production that share common data sources (annual accounts, LFR, Pillar III, MIS, COREP, ...)
 - **Training** of staff and Senior Management, as regulations become ever more complex
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How PwC can help

Many different aspects and facets to consider



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