

Flash News

Basel III:

Announcement of 12 September 2010: A big step forward – but a long way to go

October 29, 2010

Regulatory context

On 12 September 2010, after months of consultation, the Basel Committee on Banking Supervision (BCBS) announced a broad agreement on a package¹ – commonly referred to as ‘Basel III’ – that will significantly increase the capital and liquidity requirements for banks.

Although some requirements remain seemingly unchanged, it would be wrong to equate Basel II ratios with Basel III ratios, as some far-reaching changes are introduced.

This Flash News follows up on the topic already developed in our previous edition² and elaborates on the main impacts for Luxembourg banks for both capital and liquidity aspects.

1. Key modifications to the Basel II capital framework

The Committee has set out a series of new or altered requirements. The most important modifications relate to increased capital requirements:

- Introduction of a more stringent minimum common equity capital ratio;
- Calibration of the ‘capital conservation buffer’;
- Confirmation of a countercyclical buffer;
- Confirmation of the introduction of a non-risk-based leverage ratio;
- Extra requirements for systemically important banks.

Furthermore, transition periods for key elements – ranging from 2013 to 2019 – have been defined to allow banks to have sufficient time periods to implement the regulatory changes. Banks should however not wait to react, as supervisory monitoring and observation periods will begin before 2013.

Introduction of more stringent minimum common equity and Tier 1 capital ratios

Importance in Luxembourg: HIGH

Under the agreements reached on 12 September, the minimum requirement for common equity, the highest form of loss absorbing capital (solely composed of equity and retained earnings after the application of stricter adjustments), will be set to 4.5%. This is a significant increase on the level of 2% that is currently the norm (though not always formally defined) in some countries. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments (e.g. some instances of preferred shares and minority interests) based on stricter criteria, will increase from 4% to 6% over the same period.

The total capital requirement remains at the existing level of 8.0% and so does not need to be phased in. The 2% difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital. This can have a significant

¹ <http://www.bis.org/press/p100912.pdf>

² http://www.pwc.com/en_LU/lu/banking/docs/pwc_flash_23022010.pdf

impact on some Luxembourg banks partly capitalised with some forms of subordinated debt.

On a consolidated basis, the Basel Committee will allow “some prudent recognition” of the minority interest of a subsidiary that is a bank. The excess capital above the minimum of the subsidiary will be deducted in proportion to the minority interest share, provided the parent bank or affiliated has not entered into any arrangements to directly or indirectly fund the minority interest.

Calibration of the ‘capital conservation buffer’

Importance in Luxembourg: HIGH

The capital conservation buffer above the regulatory minimum requirement is confirmed and calibrated at 2.5% and is to be met with common equity, after the application of deductions. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions.

It is important to note that this capital conservation buffer will lead to a significant increase in capital requirements for many banks that should be taken into account as of today, as it might require raising new capital (or prudent earnings retention), so as to maintain a minimum total capital ratio of 10.5% except in exceptional circumstances.

If the Basel Committee foresees the progressive phasing in of this conservation buffer between 2016 and 2019, it is worth noting that national authorities have the discretion to impose shorter transition period. This phasing-in period illustrates how long the Basel Committee believes it will take some banks to generate capital.

Confirmation of a countercyclical buffer

Importance in Luxembourg: MEDIUM

The Basel committee confirms that a countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. The exact implementation measures are yet to be defined and a consultative document³ is still out on the subject.

The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system wide build-up of risk. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.

The Basel Committee adds that countries that experience excessive credit growth should consider accelerating the build-up of the said countercyclical buffer. This element of the new rules, whilst agreed in principle, still requires the regulators to develop clear guidelines as to how countercyclical capital buffers may be applied, and how and when they may be released.

Confirmation of the introduction of a non-risk-based leverage ratio

Importance in Luxembourg: MEDIUM

The above capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. In July⁴, the BCBS agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period starting in 2013. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based

on appropriate review and calibration.

Clarification has been given for off-balance sheet items, as uniform credit conversion factors will be applicable. The only factor concretely specified is for unconditionally cancellable off-balance sheet commitments, which are assigned a factor of 10%. Derivative exposures will be calculated by applying existing Basel II netting rules in addition to a simple measure of potential future exposure based on the standardised factors of the current exposure method.

The leverage ratio will be calculated as an average over a quarter. The current design appears to address significant industry concerns expressed during the consultative phase.

Extra requirements for systemically important banks

Importance in Luxembourg: MEDIUM

Systemically important banks should have loss absorbing capacity beyond the standards described above. Work continues on this issue in the Financial Stability Board (‘FSB’) and relevant Basel Committee work streams. The Basel Committee and the FSB are developing an integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. Practical implications at European and Luxembourg level are still unclear at this stage, as work on these aspects is first subject to validation by G-20 members.

³ <http://www.bis.org/publ/bcbs172.pdf>

⁴ http://www.pwc.com/en_LU/lu/banking/docs/pwc_flash_23022010.pdf

Key modifications to the Liquidity framework

Liquidity coverage ratio

Importance in Luxembourg: HIGH

The Basel Committee has revised a number of details of the liquidity coverage ratio (LCR). The treatment of retail and small business deposits as well as some unsecured wholesale funding and credit lines has been alleviated to a certain extent.

A significant development for Luxembourg is the recognition of the role of financial infrastructure providers in the calibration of the LCR. A 25% outflow bucket for custody and clearing and settlement activities, as well as selected cash management activities will be introduced. While these activities will be subject to specific supervisory approval before the respective activities could be considered “operational”, this aspect can be considered as a major alleviation for Luxembourg banks.

Several modifications are introduced regarding the definition of highly liquid assets. As part of the narrow definition of liquid assets, it will be allowed to include domestic sovereign debt of non-0% risk weighted sovereigns issued in foreign currency, to the extent that this currency matches the currency needs of the bank's operations in that jurisdiction. More significantly, a “level 2” of liquid assets, capped at 40% of the stock of liquid assets, will be introduced, including the following assets:

- Government and Public Sector Entities (PSE) assets qualifying for the 20% risk weighting under Basel II's standardised approach for credit risk, subject to a 15% haircut;
- High-quality non-financial corporate and covered bonds not issued by the bank itself (e.g. rated AA- and above), subject to a 15% haircut.

Furthermore, it is pointed out that ratings and additional criteria specified in the December proposals will be utilised in determining eligibility. However, no further details are provided for the moment.

A further point which was of major concern to the industry is equally addressed in the Committee specifying that operational requirements for the liquidity buffer will be finalised by the end of the year.

Net stable funding ratio

Importance in Luxembourg: MEDIUM

Regarding the net stable funding ratio (NSFR), the Committee reaffirms its commitment to introduce the ratio as a longer-term structural complement to the LCR. However, it is acknowledged that the initial calibration of the NSFR needs to be modified, in particular to account for differences in the business models of different institutions. In addition to potential modifications to a variety of “available stable funding”- and “required stable funding”- factors assigned to assets and liabilities, respectively, the Committee states it will continue to consider further structural changes to the NSFR.

The Committee intends to publish a set of proposals on the NSFR by the end of the year, which will be subject to testing during an extensive observation period.

Timing & transition periods – Liquidity standards

A major concern expressed by the industry was the timing of the implementation of the proposals and the related phase-in of the individual requirements. While the Committee does not specify the exact timing related to the finalised package of reforms in general, it appears the intent is to finalise the proposals by December 2010. However, the timeline of the implementation remains open as of yet, although concrete periods are provided related to the following reforms.

An observation period for the liquidity coverage ratio will begin from 2011 onwards, with a timeline for final implementation set at January 1st, 2015. The net stable funding ratio will be subject to an extensive observation phase in order to avoid unintended consequences “across business models and funding structures” when implementing the ratio. The Committee is aiming to introduce the ratio as a minimum standard by January 1st, 2018.

The Committee states rigorous reporting processes will be put in place to monitor the ratios and continuously review their implications for financial markets, credit provision and economic growth during the transition period. It is thus likely banks will be required to perform extensive developments regarding their procedural infrastructures and IT landscapes in order to be able to meet expectations by the respective supervisors.

3. Next steps

Looking ahead to next steps, it should be remembered that the proposals are still subject to approval by the G20, and the key milestone will be the G20 meeting in November 2010. In addition, a series of other initiatives are moving forward, notably:

- The consultations on capital buffers and ‘gone concern’ capital, to be completed around the end of 2010,
- The calibration of the Liquidity Coverage Ratio and Net Stable Funding Ratio, to be completed at the end of 2010,
- Accounting standard changes targeted for 2011 (for example relating to forward-looking provisions),
- National and regional changes, such as the new EU white paper on bank governance at the end of 2010. As a point of detail, we note that some of the proposed transition arrangements are out of line with current EU legislation and present a challenge to EU banks which had started implementation based on CRD timelines.

4. Conclusion

The amendments the Basel Committee introduces can be perceived as a constructive response to both G20 and industry concerns and suggestions voiced in the consultative phase, despite the fact that significant aspects of the reform package still need to be specified.

What transpires from all the above is that there is much for banks to do. Although banks now have some firm numbers and can start business planning with greater certainty, each bank will need to think through the unique implications of the changes for itself and what its response should be. For example, banks will need to:

- Plan capital and liquidity needs in the new world. They will need to plan soon how they want to meet the new ratios, and deal with issues specific to their own position, for example phasing out existing (and increasingly expensive, from a regulatory perspective) non-equity tier 1 and tier 2 instruments and replacing them with funding appropriate

to the new regime. In Luxembourg this would typically force banks to reconsider their subordinated loan situations.

- Ensure that they have robust capital management processes. The new regime will cause many banks to look again at how these operate and how they allocate capital resources (even to the extent of changing business models).
- Strengthen governance and risk management, for example in the area of liquidity risk, where many solutions to date have been tactical.

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