BASEL III
IMPLEMENTATION IN EUROPE

Peter Green
Jeremy Jennings-Mares
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Outline

• Basel III/ CRD4 proposals:
  ➢ capital requirements – quantity, quality and loss absorption
  ➢ capital buffers – capital conservation and countercyclical
  ➢ leverage
  ➢ liquidity
  ➢ counterparty credit risk

• Interaction with other global/European initiatives
Basel III - Overview

• Final Basel III rules published in December 2010:
  ➢ minimum capital requirements (quality, quantity, buffers)
  ➢ leverage ratio
  ➢ liquidity ratios
  ➢ counterparty credit risk

• January 2011 – BCBS published minimum requirements for loss absorbency of regulatory capital at the point of non-viability

• BCBS/ FSB proposals in relation to G-SIBs and additional loss-absorbency requirement:
  ➢ proposals published on 19 July 2011
  ➢ final rules published on 4 November 2011
CRD4 - Overview

- Consolidates previous European legislation – CRD, CRD2 and CRD3
- Enacts Basel III in Europe
- Governs prudential regulation and supervision of European banks and investment firms, which entails necessary changes to Basel III
- Consists of a draft directive and a draft regulation:
  - effect of different legislative forms
  - impact on national initiatives e.g. ICB Report in UK
Basel III Capital Requirements

- Common Equity Tier 1 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%
Basel III Capital Requirements (cont.)

- Tier 1 capital:
  - common equity tier 1 capital
  - non-common equity instruments meeting specific criteria (Additional Tier 1 capital)

- Common Equity Tier 1 Capital:
  - 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)
Basel III 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
Basel III 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 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
• 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
Basel III Additional/hybrid Tier 1 Capital

To be classified as tier 1 capital, the criteria for non-common equity instruments (Additional Tier 1 capital) includes:

- subordinated on liquidation to all depositors and all creditors (including subordinated creditors)
- not secured or guaranteed
- perpetual, with no incentives to redeem and no investor put option
- fully discretionary (cancellable) non-cumulative dividends/coupons
- callable by bank only after 5 years, but no expectation of redemption to be created
- any return of capital only with prior supervisory authorisation
- capable of loss absorption on a going concern basis i.e. principal write down or conversion into common equity at pre-specified trigger point
- no feature which hinders recapitalisation
Basel III Tier 2 Capital Requirements

• Minimum Tier 2 Capital 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
Basel III Gone Concern Loss Absorption

- January 2011 BCBS “gone concern” proposal – minimum requirements for loss absorption at point of non-viability
- Applies to all Additional Tier 1 and Tier 2 instruments
- Principal write-off/conversion into Common Equity Tier 1 Capital 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
- Determination of occurrence of trigger event is by relevant national competent authority
Basel III / CRD4 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 minimum Tier 1 capital to be raised to 4.5% in 2013, 5.5% in 2014 (4.5% under CRD4) 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:
  ➢ capital instruments that no longer qualify as Tier 1 or Tier 2 capital, and issued before 12 September 2010 (or 20 July 2011 under CRD4) will be gradually derecognised from 1 January 2013 over 10 years
  ➢ other capital instruments no longer qualifying as Common Equity will be excluded from 1 January 2013

• CRD4 provides some flexibility to accelerate/ decelerate phasing in and grandfathering
Basel III / CRD4 Minimum Capital Requirements

* 4.5% under CRD4
CRD4 – Quality of Capital

• Closely aligned with Basel III

• Regulatory adjustments/deductions from Tier 1 capital more specific than Basel III

• Common Equity Tier 1 capital:
  ➢ common shares, as well as other instruments meeting common equity quality criteria, to be specified by EBA
  ➢ cut off date for phasing out non-qualifying instruments is 20 July 2011 – for Basel III, 12 September 2010
  ➢ regulatory adjustments for investments in insurance undertakings – deduction or alternative treatment under Financial Conglomerates Directive
CRD4 – Loss Absorption

• Going–concern loss absorption for Additional Tier 1:
  - write-down or conversion to equity at pre-specified trigger point
  - minimum CET1 capital to total risk weighted assets of 5.125%
  - applies to “equity” as well as “liabilities” according to accounting treatment
  - instrument’s terms to prescribe conversion terms e.g. conversion ratio
  - EBA to draft technical standards regarding procedures and timings regarding conversions and write-downs of principal

• “Not hindrance to a recapitalisation”
  - dividend stoppers, dividend pushers, alternative coupon satisfaction mechanisms prohibited
CRD4 – Loss Absorption (cont.)

• Gone-concern loss absorption:
  - for Additional Tier 1 and Tier 2, Basel III mandated principal write down or conversion to equity at point of institution’s non-viability
  - to be effected either by the instrument’s terms, or by provisions of general laws of the institution’s jurisdiction
  - provisions not enacted in CRD4
  - expected in European Framework for Bank Recovery and Resolution?
Basel III / CRD IV Capital Conservation Buffer

• Additional capital buffer of 2.5% of risk weighted assets

• To comprise Common Equity Tier 1 capital

• 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
Basel III 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 capital conservation buffer
  ➢ decisions should be pre-announced by 12 months
• Banks should calculate the buffer with at least the same frequency as their minimum capital requirements
CRD4 – Capital Buffers

- Capital conservation buffer mirrors equivalent Basel III provisions
- Countercyclical capital buffer:
  - set by individual member states in periods of excessive credit for institutions to build up additional capital buffer against future losses
  - between 0% and 2.5% of risk weighted assets
  - to be comprised only of Common Equity Tier 1 capital
  - institution’s buffer based on weighted average of buffer rates in countries where its exposures are located
  - EU member states set buffers quarterly based on comparison of current credit-to-GDP ratio to long term average, and on guidance from ESRB
  - member states able to set national rates at higher than 2.5%, but other national regulators not obliged to give effect to rate of more than 2.5%
Counterparty Credit Risk ("CCR") Framework

- Basel III makes significant changes to CCR framework with effect from 2013.
- Measures designed to strengthen risk coverage include:
  - 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
- European Markets and Infrastructure Regulation will mandate central clearing of many OTC derivative transactions, as well as introducing new prudential regulations for central clearing counterparties
- BCBS consultations (December 2012, November 2011) on capitalisation requirements for bank exposures to CCPs and bases proposals on CPSS – IOSCO principles for Financial Market Infrastructures
- Trade exposures to qualifying CCPs proposed risk weighting of 2%, but higher for other counterparties, including non-qualifying CCPs
CRD4 – Counterparty Credit Risk

• Counterparty Credit Risk Framework:
  ➢ CRD4 follows Basel III proposals including additional capital charges for exposures to OTC derivatives and securities financing transactions
  ➢ 2% risk weighting for exposures to qualifying CCPs
  ➢ higher risk weightings for exposures to other counterparties, including non-qualifying CCPs
Global Systemically Important Banks - Additional Loss Absorbency

- BCBS proposals on determining G-SIBs and additional loss absorbency requirements:
  - sets out methodology for determining G-SIBs
  - initial list of 29 G-SIBs published
  - list to be updated annually (in November)
- Between 1% to 2.5% of risk weighted assets in addition to standard Basel III requirements (with potential to increase to 3.5%)
- Additional loss absorbency requirement to apply from 2016
- Basel III prescribes only Common Equity Tier 1 capital for additional capital requirements
- CRD4 currently has no G-SIB provisions
Basel III 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 1 January 2018
- Ratio measures banks’ capital (the numerator) compared to their Exposure (the denominator) on new definition of Tier 1 capital.
- Exposure should follow accounting standards
Basel III Leverage Ratio (cont.)

- 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
CRD4 - Leverage Ratio

• Leverage Ratio:
  - ratio monitoring period from 1 January 2013 to 1 January 2017
  - monitor Tier 1 capital as percentage of total assets – total assets determined in line with accounting treatment
  - “intention” of Commission to introduce binding ratio from 2018 – must report to European Parliament by end of 2016
Basel III 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
Basel III 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
Basel III 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
CRD4 – Liquidity Ratios

• Liquidity Cover Ratio:
  ➢ binding ratio to be introduced in 2015
  ➢ detail less prescriptive than Basel III on liquidity weightings given to different assets
  ➢ obligation to hold sufficient liquid assets to cover net liquidity outflows for a short period under stressed conditions

• Net Stable Funding Ratio:
  ➢ observation period up to 2018, but currently no absolute obligation to maintain a particular ratio
  ➢ Commission “committed” to reaching minimum standard by 2018
  ➢ EBA to report to Commission by end 2015
  ➢ Commission to report to European Parliament by end of 2016 on whether institutions should be required to maintain a particular ratio
CRD4 - Timing

• To be passed by European Parliament by June 2012

• Draft technical standards from EBA by 1 January 2013

• EU member states to arrange transposition/implementation by 1 January 2013

• Related future initiatives expected:
  ➢ European Framework for Recovery and Resolution
  ➢ EMIR