News Bulletin

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Basel III: The (Nearly) Full Picture

Following endorsement of its proposed reforms of the Basel II framework at the G20 Seoul Summit in November 2010, the Basel Committee on Banking Supervision ("BCBS") published the final Basel III rules on 16 December 2010. The rules are contained in two separate documents: (1) Basel III: A global regulatory framework for more resilient banks and banking systems and (2) Basel III: International framework for liquidity risk measurement, standards and reporting,[1] together with the results of the BCBS's comprehensive quantitative impact study ("QIS").[2]

We summarise below certain of the key features of the new Basel III rules.

Quality and Quantity of Capital

As foreshadowed in their December 2009 proposals[3] and the revised July 2010 proposals,[4] BCBS has resolved that the predominant form of bank capital should be common shares (or the equivalent for non-joint stock companies), retained earnings and other reserves ("Common Equity Tier 1 Capital"); deductions from capital and prudential filters must be harmonised internationally and generally applied at the level of common equity; Tier 1 capital instruments other than Common Equity Tier 1 Capital ("Additional Tier 1 Capital") must have very strong equity-like characteristics, such as deep subordination and fully discretionary, non-cumulative dividend/coupon payments, and must be perpetual and contain no incentive to redeem; capital instruments other than Tier 1 Capital ("Tier 2 Capital," since Tier 3 will be eliminated) will need to contain certain minimum, harmonised characteristics; and all elements of capital will be required to be disclosed and reconciled to the bank's reported accounts.

1. Definition of Capital

The definition of capital is substantially the same as initially proposed in December 2009, except as to certain regulatory adjustments applicable to Common Equity Tier 1 Capital which were modified and relaxed in July 2010.

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[1] Basel III: A global regulatory framework for more resilient banks and banking systems (16 December 2010), http://www.bis.org/publ/bcbs189.pdf, and Basel III: International framework for liquidity risk measurement, standards and reporting (16 December 2010), http://www.bis.org/publ/bcbs188.pdf.

[2] BCBS Results of the comprehensive quantitative impact study (16 December 2010), http://www.bis.org/publ/bcbs186.pdf.

[3] *See* Morrison & Foerster client alert: More, More, More: A Summary of the Basel Proposals (2 February 2010), http://www.mofo.com/files/Publication/2f280bc1-1b9a-4d98-929f-0a4554236d0f/Presentation/PublicationAttachment/7cf62184-8f7b-48c4-a4f8-1de08055cfe4/SummaryoftheBaselProposals02022010.pdf.

[4] *See* Morrison & Foerster client alert: A little bit less and a bit longer: Update on Basel Capital & Liquidity Reforms (6 August 2010), http://www.mofo.com//files//Uploads/Images/100806BaselCapital.pdf.

Total Capital consists of (i) Tier 1 Capital (going-concern capital), comprising Common Equity Tier 1 and Additional Tier 1 Capital, and (ii) Tier 2 Capital (gone-concern capital).

Common Equity Tier 1 Capital consists of (i) common shares issued by the bank; (ii) any resulting stock surplus (share premium); (iii) retained earnings; (iv) accumulated other comprehensive income and other disclosed reserves; and (v) common shares issued by its consolidated subsidiaries qualifying as Common Equity Tier 1 Capital and held by third parties (i.e., minority interests), subject to regulatory adjustments.

Common shares must satisfy certain specified criteria, including the following: (i) in a liquidation, be the most subordinated claim; (ii) be perpetual (i.e., no redemption/maturity date), without creating any expectation for redemption; (iii) have non-obligatory distributions (i.e., non-payment is not an event of default); (iv) absorb losses on a going-concern basis; and (v) be neither secured nor guaranteed.

An instrument that does not constitute a common share (or equivalent for non-joint stock companies) may still constitute ***Additional Tier 1 Capital*** if it meets certain criteria, including:

- as to permanence:
  - be perpetual, without any incentive for the issuer to redeem (e.g., interest rate step-ups);
  - be callable by the issuer only after a minimum of five years, and only with prior supervisory approval; and
  - have its principal repayable (whether on redemption or buy-back) only with prior supervisory approval.
- as to flexibility of payments:
  - dividends/coupons must be fully discretionary (i.e., cancellable on a non-cumulative basis); and
  - must not have any credit-sensitive dividend feature.
- as to loss absorbency:
  - in a liquidation be subordinated to all depositors and creditors, including holders of subordinated debt (i.e., it must be senior only to common equity);
  - not contribute to liabilities exceeding assets under any balance sheet solvency test; and
  - debt instruments must have principal loss absorption capacity through mandatory conversion to common shares or write-down at a pre-specified trigger point, and otherwise not have any feature which hinders recapitalisation.

An instrument that does not qualify as Tier 1 Capital may still constitute ***Tier 2 Capital*** if it meets certain criteria, including:

- as to permanence:
  - have a minimum original maturity of at least five years, with no incentive to redeem; and
  - be callable only by the issuer and only after a minimum of five years, with prior supervisory approval.
- as to flexibility of payments:
  - not have a credit-sensitive dividend feature.
- as to loss absorbency:
  - in a liquidation be subordinated to depositors and unsubordinated creditors.

In the case of both Additional Tier 1 and Tier 2 instruments, if issued through a non-operating entity or SPV, the issue proceeds must be immediately available to an operating entity or holding company in the consolidated group.

Regulatory adjustments: In calculating the Common Equity Tier 1 Capital, certain items must be fully deducted or de-recognised, including:

- goodwill and other intangibles (except mortgage servicing rights);
- deferred tax assets ("DTAs") whose realisation depends on the bank's future profitability;
- cashflow 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; and
- unrealised gains and losses resulting from changes in bank's own credit risk on fair valued liabilities.

In addition, certain assets, such as significant investments in the common shares of unconsolidated financial institutions; mortgage servicing rights; and DTAs arising from timing difference, will be given only limited recognition as Common Equity Tier 1 Capital.

Disclosure requirements: To improve transparency of regulatory capital, banks will be required to disclose in their audited financial statements information regarding the instruments included in their regulatory capital and a full reconciliation of all those elements back to their balance sheets. BCBS has stated that it will issue more detailed Pillar 3 disclosure requirements in 2011.

2. Minimum Capital Standards

As foreshadowed in the BCBS 12 September 2010 press release,[5] the new minimum capital requirements will be phased in between 1 January 2013 and 1 January 2015, as follows:

	From 1 January 2013	From 1 January 2014	From 1 January 2015
Common Equity Tier 1/ Risk-weighted assets ("RWAs")	3.5%	4.0%	4.5%
Tier 1 Capital/ RWAs	4.5%	5.5%	6.0%
Total Capital/ RWAs	8.0%	8.0%	8.0%

Regulatory adjustments will be phased in at 20% of the required adjustments to Common Equity Tier 1 per annum, starting at 20% on 1 January 2014, building to 100% from 1 January 2018. The same approach will apply to deductions from Additional Tier 1 and Tier 2 Capital.

Existing instruments that no longer qualify as non-Common Equity Tier 1 or Tier 2 Capital will be gradually phased out. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10% in each subsequent year. Existing public sector capital injections will be grandfathered until 1 January 2018.

[5] *See* Morrison & Foerster client alert: The New Global Minimum Capital Standards Under Basel III (15 September 2010), http://www.mofo.com/files/Uploads/Images/100915-Basel-III.pdf.

3. Capital Conservation Buffer

To encourage banks to build up capital buffers which can be drawn upon during a severe stress period, Basel III introduces a capital conservation buffer, consisting of Common Equity Tier 1 Capital, building up to 2.5% of RWAs over and above the minimum capital requirements.

Constraints will be imposed on a bank's ability to pay out its earnings in distributions when its capital buffer falls below the prescribed level. As shown below, a bank's minimum capital conservation ratios (i.e., the percentage of its earnings not available for distribution by way of dividend, share buy-back or discretionary bonuses to employees) will increase as its Common Equity Tier 1 Capital level nears the minimum regulatory requirement.

Common Equity Tier 1 Ratio	**Minimum Capital Conservation Ratios (as a percentage of earnings)**
4.5% - 5.125%	100%
>5.125% - 5.75%	80%
>5.75% - 6.375%	60%
>6.375% - 7.0%	40%
> 7.0%	0%

Transitional arrangements: The capital conservation buffer will be phased in, beginning at 0.625% of RWAs on 1 January 2016 and, rising by an additional 0.625% each year, reaching its full level of 2.5% on 1 January 2019.

4. Countercyclical Buffer

To curb excess credit growth, countercyclical buffers will be implemented, on a national basis, through an extension of the capital conservation buffer/ratios and corresponding restrictions on distributions.

If the relevant national supervisory authority determines that excess credit growth is leading to the build up of system-wide risk in its jurisdiction, it may ask banks to create a countercyclical buffer of up to 2.5% of RWAs. BCBS has issued guidance to assist national regulators in making buffer decisions and banks in understanding them.[6] A high degree of cooperation will be needed among regulators to ensure that the buffer requirements are applied consistently to cross-border banks.

Risk Coverage

In addition to changes addressing the quality and quantity of banks' capital, the Basel III text makes significant reforms to the existing counterparty credit risk ("CCR") framework, with effect from 1 January 2013. Broadly, the effect of these reforms is to increase the capital charges associated with exposure to counterparties to OTC derivatives, repos and stock lending transactions, in each case, which are not cleared through central counterparties ("CCPs") and thus provide incentives to employ more standardised derivatives to be cleared centrally.

BCBS acknowledges the ongoing work of the Committee on Payment and Settlement Systems ("CPSS") and the International Organisation of Securities Commissions ("IOSCO") in reviewing and revising the 2004 CPSS-IOSCO Recommendations for CCPs to address the systemic risk arising from the interconnectedness of financial

[6] BCBS Guidance for national authorities operating the countercyclical capital (16 December 2010), http://www.bis.org/publ/bcbs187.pdf.

institutions through the derivatives markets. Among other things, the revised Recommendations are intended to cover the risk management of CCPs.

In this regard, BCBS has also issued a separate consultative document setting out its proposals relating to the capitalisation of bank exposures to CCPs and inviting comments until 4 February 2011.[7] Whereas the Basel II framework permits exposures to CCPs to be given a risk weighting of zero, BCBS now proposes that trades cleared through "qualifying CCPs" that meet the revised CPSS-IOSCO standards be subject to a risk weight of 2%, to reflect the fact that even regulated CCPs are not completely free of risk. Exposures to non-qualifying CCPs are proposed to be treated in the same way as any other non-centrally cleared, bilateral, OTC derivatives exposure, attracting significantly higher capital charges. BCBS expects to finalise its proposals by September 2011.

Enhanced CCR management: The Basel III rules bolster the existing requirements as to a bank's CCR management in a number of ways, e.g., (i) expanding the CCR stress testing requirements for banks using the internal model method ("IMM"), and (ii) initial validation and ongoing review and regular back-testing of its IMM approach.

External credit ratings: To try and address the BCBS's view that the existing capital framework has encouraged investors to place too much reliance on external credit ratings, the following requirements will be introduced by Basel III:

- An issue-specific rating assessment may only be applied by a bank to an unrated issue by the same issuer if the unrated issue ranks pari passu with or senior to the rated issue; if the borrower has an issuer rating, only senior claims on that issuer will benefit from the issuer rating;
- Banks should develop methodologies to assess for themselves the credit risk of securitisation exposures, whether externally rated or unrated;
- In determining the eligibility of an external credit assessment institution ("ECAI"), national supervisors should refer to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies;
- Certain changes to the eligibility criteria, for credit risk mitigation purposes, of entities providing credit protection, in order to eliminate certain "cliff-effects"; and
- Banks must use the chosen ECAIs and their ratings consistently for both risk weighting and risk management purposes. In general, banks should use solicited ratings from eligible ECAIs, but national supervisors may allow them to use unsolicited ratings.

BCBS is also conducting a more fundamental review of the securitisation framework, including its reliance on external ratings.

Leverage Ratio

To constrain the build-up of excessive leverage in the banking system, a new leverage ratio will be introduced, based on banks' Capital compared to their Exposure as follows:

Capital will be based on the new definition of Tier 1 Capital and items that are deducted from Capital should also be deducted from the Exposure.

Exposure should follow accounting standards, as follows:

[7] BCBS Consultative Document: Capitalisation of bank exposures to central counterparties (20 December 2010), http://www.bis.org/publ/bcbs190.pdf.

- On-balance sheet, non-derivative exposures must be net of specific provisions and valuation adjustments must be stated without deduction of physical or financial collateral, guarantees or credit risk mitigation purchased and no netting of loans and deposits is allowed;
- Exposure to repos, reverse repos and stock loans should be calculated by applying the accounting measure of exposure and the Basel netting rules; and
- Further detailed rules are applicable in respect of derivatives and off-balance sheet items.

The transition period for the leverage ratio will consist of (i) a supervisory monitoring period from 1 January 2011, and (ii) the parallel run period from 1 January 2013 until 1 January 2017, during which BCBS proposes to test a minimum leverage ratio of 3%. Bank level disclosure of the leverage ratio and its components will start on 1 January 2015.

Basel III Liquidity Rules

The document entitled "Basel III: International framework for liquidity risk measurement, standards and reporting" sets out the amended rules relating to liquidity, including the details of the two new liquidity ratios to be applied by banking supervisors.

1. Liquidity Standards

BCBS has developed two separate standards for supervising liquidity risk.

The Liquidity Coverage Ratio ("LCR") is designed to ensure that banks have a sufficient stock of high-quality liquid assets to survive a significant liquidity stress scenario lasting 30 days. LCR builds on the traditional internal methodologies used by banks to assess exposure to contingent liquidity events and is defined as (stock of high-quality liquid assets) ÷ (total net cash outflows over the next 30 days). A bank's LCR must be at least 100%. The scenario envisaged by BCBS involves combining many of the factors experienced by banks in the last few years, such as reductions in retail deposits, reductions in unsecured wholesale funding capacity, etc. into one huge multi-faceted stress scenario.

Certain high-quality liquid assets would be included on the asset side on an unlimited, undiscounted basis, whereas other lesser-quality/less liquid assets would be discounted and their eligibility limited to 40% of the overall stock.

The Net Stable Funding Ratio ("NSFR") is designed to promote resilience over a longer period of one year by encouraging banks to fund themselves with a minimum amount of equity and debt financing which is expected to be a reliable source of funds over a one-year period under conditions of extended stress. NSFR builds on the traditional "net liquid asset" and "cash capital" methodologies used by internationally-active banks.

The ratio will provide that a bank's Available Stable Funding ("ASF") must be at least equal to its Required Stable Funding ("RSF").

ASF is defined as the total sum of a bank's (a) capital; (b) preferred stock with a maturity of one year or more; (c) liabilities with effective maturities of one year or more; and (d) that portion of non-maturity deposits, term deposits and/or wholesale funding with maturities of less than one year which is expected to stay with the bank for an extended period in a stress event. A factor will be applied to discount each funding item's face value for the purpose of the NSFR, with less stable funding sources receiving a higher discount factor.

RSF is defined as the amount of stable funding required by supervisors and is to be measured using supervisory assumptions on the liquidity risk profiles of an institution's assets, OBS exposures and other selected activities. The RSF amount is calculated by taking the value of each asset held by the bank and applying a factor of between

0% and 100% to that value, depending on the assessment of how readily that asset could be realised by the bank – with cash receiving a factor of 0%.

2. Application Issues

Reporting: LCR should be reported at least monthly, or more frequently in stressed situations, at the discretion of the supervisor. NSFR should be reported at least quarterly.

Scope: BCBS acknowledges that there may be national differences in the liquidity treatment of certain items that are subject to national discretion. A cross-border banking group should apply the liquidity parameters adopted in the home jurisdiction to all legal entities being consolidated, except as to the treatment of retail/small business deposits which should, in most circumstances, follow the parameters adopted in host jurisdictions where the entities operate. The consolidated LCR should reflect the liquidity transfer restrictions (e.g., non-convertibility of local currency, foreign exchange controls) in relevant jurisdictions which inhibit the transfer of liquid assets and fund flows within the group.

Observation periods and transitional arrangements: The revised LCR will be introduced on 1 January 2015, and the revised NSFR will move to a minimum standard by 1 January 2018.

Observations and Next Steps

The regulatory capital provisions under Basel III have been long-anticipated. Concerns had been raised during consultations that the stringent new rules would make banks less profitable and hinder their lending activities, which are needed to support economic recovery. The amendments to the proposals in July 2010 and the lengthy transition period for the new provisions were partly designed to address those concerns. However, one of the findings of the QIS, which was based on the 2009 financial data provided by participating banks, was that the Group 1 banks which participated in the QIS would have to make up a Common Equity Tier 1 shortfall of €165bn to meet their new minimum requirements (assuming Basel III had been in place at the end of 2009) or €577bn to meet their new target requirements (so as not to be subject to any restrictions on distributions). The QIS notes that the same banks had after-tax profits for 2009 of €209bn.

The same banks would have achieved an average leverage ratio of 2.8% (compared to the proposed 3%), an average LCR of 83% (compared to the required 100%) and an average NSFR of 93% (compared to the required 100%). However, these findings arguably have limited significance given that the full details of the liquidity framework have yet to be calibrated and finalised by BCBS during the observation period, which will last until 2016.

As discussed above, BCBS is also continuing further work in relation to certain other issues, including the capitalisation of exposures to CCPs. In addition, BCBS announced that it continues to collaborate with the Financial Stability Board in relation to the additional loss absorption capacity requirements expected to be imposed on systemically-important banks and in relation to developing more detailed eligibility criteria for contingent capital, to address issues of loss absorbency at the point of a bank's non-viability.[8]

[8] *See* BCBS press release: Basel III rules text and results of the quantitative impact study issued by the Basel Committee (16 December 2010), http://www.bis.org/press/p101216.htm.

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