MORRISON | FOERSTER

News Bulletin

August 6, 2010

A Little Bit Less and a Bit Longer: Update on Basel Capital and Liquidity Reforms

Background

As we reported in our bulletin "More, More, More: A Summary of the Basel Proposals,"[1] in December 2009, the Basel Committee on Banking Supervision ("BCBS") published two consultative documents proposing significant reforms to the Basel II framework.[2] These relate to, among other things, the definition of capital, the treatment of counterparty credit risk, the introduction of a leverage ratio and the imposition of global liquidity standards (the "December 2009 Proposal").[3]

Following an extensive consultation process during which many concerns were raised as to the scope and effect of the December 2009 Proposal, including concerns that many banks and financial institutions may be unable to function with the increased capital and liquidity requirements (at least until there is a significant economic recovery), BCBS announced on 26 July 2010 that its oversight body had reached agreement on proposed capital and liquidity reforms. It also announced that it intended to finalise the calibration and phase-in arrangements for the reforms at a meeting in September 2010.

On 16 July 2010, BCBS also published its countercyclical buffer proposals for public consultation, which will continue until 10 September 2010.[4] Part of these proposals was outlined in the December 2009 Proposal.

Although the proposals in its July 2010 papers do not alter the overall thrust of the December 2009 Proposal in relation to capital and liquidity requirements, they do include some important modifications and softening of some of BCBS's earlier proposals, including substantially deferring the transitional period for the global minimum Tier 1 leverage ratio and the net stable funding ratio. Details of the new BCBS proposals were published in an Annex to its 26 July announcement (the "Annex").[5] We summarise the key features below.

---

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

[2] BIS Press Release: Group of Governors & Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package (26 July 2010), http://www.bis.org/press/p100726.htm.

[3] BCBS consultative documents (17 Dec 2009): (1) Strengthening the resilience of the banking (17 Dec 2009), http://www.bis.org/publ/bcbs164.pdf?noframes=1; and (2) International framework for liquidity risk measurement, standards and monitoring, http://www.bis.org/publ/bcbs165.pdf?noframes=1 (comments deadline: 16 April 2010).

[4] BCBS consultative document: Countercyclical capital buffer proposal (6 July 2010), http://www.bis.org/publ/bcbs172.pdf (comments deadline: 10 Sept 2010).

[5] BIS Annex (26 July 2010), http://www.bis.org/press/p100726/annex.pdf.

Definition of Capital

Whilst retaining most of the proposals relating to definition of capital in the December 2009 Proposal, BCBS has agreed to relax some of its requirements in relation to regulatory adjustments to be applied to the common equity component of Tier 1:

- *Minority interests*: A limited prudential recognition of the minority interest in a subsidiary bank will be permitted, allowing the parent bank to deduct the excess capital above a minimum level in proportion to the minority interest share. Previously there could be no recognition of such minority interests. It is stated, however, that no such recognition will be permitted where the parent bank or an affiliate has entered into any arrangements to fund, directly or indirectly, other minority investments in the subsidiary including through an SPV or other vehicle.
- *Investments in other financial institutions*: BCBS has discarded the previous restrictions on allowing net short positions to be deducted from long positions in calculating the deduction for unconsolidated investments only if the short positions involve no counterparty risk. An underwriting exemption will also be included. The requirement to deduct unconsolidated investments in financial institutions above certain minimum thresholds will continue to apply.
- *Intangible assets (e.g., software)*: An optional IFRS treatment will be allowed in determining the level of intangible assets if applying the relevant national GAAP would result in a wider range of assets being classified as intangible.
- *Significant investments (i.e., more than 10%) in the common shares of unconsolidated financial institutions; mortgage servicing rights; and deferred tax assets arising from timing differences*: When calculating a bank's common equity component of Tier 1 capital, a limited recognition is now permitted in relation to these three items, capped in each case at 10% of the bank's common equity component. Such recognition in relation to these items in the aggregate is further limited to 15% of the bank's common equity component of Tier 1 capital (as calculated prior to the deduction of these items but after all other relevant deductions). In the December 2009 Proposal all of these items were subject to a full deduction.

Counterparty Credit Risk

Various technical changes are proposed in relation to calculating counterparty credit risk including:

- relaxing the provisions relating to recognition of hedging arrangements;
- raising the threshold at which an asset value correlation adjustment will be made from US$25 billion to US$100 billion;
- subjecting banks' mark-to-market and collateral exposures to a central counterparty to a "modest" risk weight. "Modest" is not defined for these purposes but it is indicated as likely to be in the 1 to 3% range. The December 2009 Proposal had suggested there would be a zero risk weighting in these circumstances; and
- eliminating the 5x multiplier in calculating the credit valuation adjustment ("CVA") proposed in the December 2009 Proposal.

Leverage Ratio

Although the introduction of leverage ratio was announced in the December 2009 Proposal, many of the details remained unclear. Some further details are given in the Annex.

BCBS states that its aim is to develop a simple, transparent, nonrisk-based measure that is calibrated to act a supplement to the risk-based requirements. In calculating the ratio it is proposed that off-balance sheet items be subject to uniform credit conversion factors, which are not specified, although a 10% credit conversion factor is proposed for unconditionally cancellable off-balance sheet items. It is proposed that derivatives be converted to a "loan equivalent amount" by applying existing netting rules (which were not envisaged in the December 2009 Proposal) together with a measure of potential future exposure based on the standardised factors of the current exposure method.

It is proposed that the minimum Tier 1 leverage ratio be set at 3% which will be tested during a "parallel run" period between 2013 and 2017. Bank level disclosure of the leverage ratio and its components will commence in January 2015. A "supervisory monitoring period" will commence on 1 January 2011 which will focus on developing templates to consistently track the underlying components of the definition of the ratio and the resulting ratio. It is indicated that the leverage ratio will not become a binding requirement until at least the beginning of 2018.

BCBS notes that there is a strong consensus to base the leverage ratio on the new definition of Tier 1 capital, but states it will also track the impact of the ratio using total capital and tangible common equity as the numerator.

In the December 2009 Proposal, BSBC stated that it was considering alternative treatments for more complex items, such as securitisations, repurchase agreements, derivatives and off-balance sheet items. Save to the limited extent mentioned above, these issues are not considered further in the Annex.

Pro-cyclicality and Countercyclical Buffers

BCBS refers in the Annex to its consultative document of 16 July 2010 (with comments due by 10 September 2010) setting out its proposals for a countercyclical buffer proposal. Details of the proposed conservation buffer proposal were set out in the December 2009 Proposal and have not been amended. BCBS intends to finalise both proposals by the end of 2010.

In the December 2009 Proposal, BCBS stated that the four key objectives of introducing countercyclical buffers were:

- dampening any excess cyclicality of the minimum capital requirement;
- promoting more forward-looking provisions;
- conserving capital to build buffers at individual banks and the banking sector to be used in times of stress; and
- achieving the broader macroprudential goal of protecting the banking sector from periods of excess credit growth.

In the Annex, BCBS states that the capital conservation buffer should be available to absorb losses during a period of severe stress whilst the countercyclical buffer would extend the capital conservation range during periods of excess credit growth (or other appropriate national indicators).

Through a quantitative impact study, BCBS is considering ways to mitigate cyclicality, by adjusting for the compression of probability of default estimates in the internal ratings-based ("IRB") approach during benign credit conditions through the use of probability of default estimates in an economic downturn.

The following points are worth noting from BCBS's 16 July 2010 consultative document:

- The primary aim of the countercyclical buffer is stated to be to achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth associated with system-wide risk build-up and to ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned in times of financial stress. It is hoped the buffer may also temper the build-up phase of the cycle in the first place by raising the cost of credit and dampening demand.
- Each jurisdiction will be given the discretion to set the countercyclical buffer as an add-on to the minimum buffer range established by the conservation buffer. Add-on decisions would be pre-announced by 12 months to give banks time to meet the additional capital requirements before they take effect.
- Add-ons will be subject to an upper limit and will only be in effect when there is evidence of excess credit growth that is resulting in a build-up of system-wide risk. There will be no add-ons at any other times.
- Internationally active banks will look at the geographic location of their credit exposure and calculate their buffer add-ons for each exposure by reference to the applicable buffer in the jurisdiction where such exposure is located. Such arrangements will require jurisdictional reciprocity and sharing of information. The interaction between the home authority of the relevant bank and host authorities in which it operates are stated to be an area still under consideration by BCBS.
- To assist each jurisdiction in setting its buffers and to ensure international consistency, a methodology will be established together with a set of principles.
- To assist relevant authorities in operating the buffer and communicating decisions, it is proposed that the buffer framework be implemented through a combination of minimum standards in setting the buffer and disclosing information and best practice guidance setting out recommendations on how authorities can best promote accountability and transparency over buffer decisions.
- To ensure consistency with the minimum capital requirements, individual banks should ensure that their buffer add-ons are calculated with at least the same frequency as their minimum capital requirements.
- BCBS intends to maintain a website collating the prevailing buffer add-ons in effect in each jurisdiction.

Systemic Banks, Contingent Capital and Capital Surcharge

In addition to the proposed reforms to the trading book, securitisation, counterparty credit risk and exposure to other financials, BCBS proposes the following measures to address systemic risk:

- *"Gone concern" proposal*: BCBS will issue for consultation a "gone concern" proposal that requires capital instruments to be written off or converted to common shares, at the option of the regulator, if the issuer bank becomes financially troubled.
- *"Going concern" proposal*: Having reviewed an issues paper on the use of contingent capital to make up the capital buffers, BCBS will review a proposal for the treatment of "going concern" contingent capital at its December 2010 meeting.
- *"Guided discretion" approach*: BCBS will further develop the "guided discretion" approach to integrate the capital surcharge into the Financial Stability Board's initiative on systemically important financial institutions (where contingent capital may have a role).

Global Liquidity Standards

The December 2009 Proposal set out proposals for two liquidity ratios: a short-term liquidity cover ratio aimed at ensuring banks maintain 30 days' liquidity coverage for extreme stress conditions and a longer-term net stable funding ratio by reference to the amount of "longer-term, stable sources of funding" (at least one year) relative to the "liquidity profiles" of the assets funded and the off-balance sheet exposures.

Liquidity coverage ratio

Various changes to the detailed calculation of "liquid assets" and other elements of the ratio have been proposed. These changes include treating commitments of sovereigns and central banks in a manner similar to non-financial corporates and requiring that all assets in the liquidity pool for the definition of liquid assets be managed as part of the pool and be subject to operational requirements (to be finalised by the end of this year) and introducing a "level 2" of liquid assets which can comprise up to 40% of the pool.

Net stable funding ratio

BSBC states that it remains committed to introducing a net stable funding ratio but that the proposals for its calibration set out in the December 2009 Proposal require significant modification. It states that it is considering, in particular, amending the calibrations relating to retail and SME deposits, mortgages and off-balance sheet commitments. A modified proposal will be produced for consultation by the end of 2010.

It also states that it will carry out an "observation phase" to test the effect of the ratio and that its current timetable for introducing the ratio as a minimum standard is 1 January 2018.

Effect of the Proposals and Next Steps

As indicated above, there are still aspects of the proposals that require further clarification although, in most cases, BCBS has indicated that it intends to publish full details of the proposals by the end of 2010.

Although the main elements of the December 2009 Proposal remain intact, there has been a significant softening of some the proposals, including allowing recognition of some items in calculating Tier 1 capital that were previously excluded, including minority interests in consolidated bank subsidiaries, a relaxation of some of the calculations of capital charges for counterparty credit risk in relation to derivatives and repo transactions.

It is still intended that the bulk of the proposals will be implemented by the end of 2012. However, the time frame for some important elements of the proposals, notably the introduction of the leverage ratio and net stable funding ratio, has been deferred until at least the start of 2018.

Contacts

Peter Green
+44 20 7920 4013
pgreen@mofo.com

Helen Kim
+44 20 7920 4147
hkim@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.