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More, More, More: A Summary of the Basel Proposals

Background

Released in 1976, the song "More, More, More" became a disco chart-topper. "More, more, more; how do you like it?" was the song's refrain. It also happens to be a good summary for the Basel Committee on Banking Supervision's ("BCBS") long-awaited proposals. In short: more capital, more emphasis on Tier 1 capital, more risk coverage requirements, more regulatory adjustments to be applied to the common equity component of Tier 1, and more transparency.

In mid-December 2009, BCBS published its consultative documents on "Strengthening the resilience of the banking sector"[1] and the "International framework for liquidity risk measurement, standards and monitoring,"[2] which we refer to, together, as the Basel Proposals. The Basel Proposals aim to address shortcomings in the Basel II capital framework, such as flaws in the definition of capital that compromise quality and market discipline and pro-cyclicality, which contributed to amplifying the effect of financial shocks. The Basel Proposals are intended to "promote a better balance between financial innovation, economic efficiency, and sustainable growth over the long run." The proposals already have drawn criticism from bankers and national regulators who have expressed concerns that BCBS is pushing ahead too quickly under political pressure from G20 leaders and that the new rules may unduly curtail banks' lending capacity.

Interested parties are requested to provide comments by April 16, 2010. BCBS has stated that it plans to issue, by the end of 2010, a fully calibrated, comprehensive set of proposals, which banks will then be given time to implement in "phases" by December 31, 2012.

Strengthening the Resilience of the Banking Sector

The Basel Proposals address the quality, consistency and transparency of the capital base, emphasizing common equity as the principal component of Tier 1 capital; require enhanced risk coverage through enhanced capital requirements for counterparty credit risk; introduce a non-risk adjusted leverage ratio; and set forth measures to improve a countercyclical capital framework.

[1] BCBS Consultative Document: Strengthening the resilience of the banking sector (17th December 2009), http://www.bis.org/publ/bcbs164.pdf?noframes=1 (comments by 16th April 2010).
[2] BCBS Consultative Document: International framework for liquidity risk measurement, standards and monitoring (17th December 2009), http://www.bis.org/publ/bcbs165.pdf?noframes=1 (comments by 16th April 2010).

Capital

The Basel Proposals attempt to correct gaps in the existing definition of capital under the Basel II framework, including, that:

- regulatory adjustments are not generally applied to the common equity component of the capital, which has allowed banks to report high Tier 1 ratios despite low common equity levels;
- regulatory adjustments and accounting rules are not harmonized among different countries, which has undermined the consistency of regulatory capital; and
- banks have not been required to provide sufficient disclosure about their regulatory capital base, which has undermined market discipline and prevented an accurate assessment of quality, as well as meaningful comparisons among banks.

To rectify these perceived deficiencies, the Basel Proposals emphasize that: Tier 1 capital must help a bank remain a going concern; regulatory adjustments must be applied to the common equity component of capital; regulatory capital must be simple and harmonized for consistent application across jurisdictions; and regulatory capital components must be clearly disclosed in order to promote market discipline.

Definition of Capital

Tier 1 capital is that part of a bank's regulatory capital which is fully loss absorbent on a going-concern basis, whereas Tier 2 capital is expected to bear losses on a gone-concern (or insolvency) basis.

Tier 1 Capital (Going-Concern Capital)

Tier 1 capital must consist predominantly of "common equity," which includes common shares and retained earnings. The new definition of Tier 1 capital is closer to the definition of "tangible common equity," which, during the financial crisis, has become the de facto indicator for investors of capital strength.

In order to be classified as Tier 1 capital, non-common equity has to satisfy specific criteria, including the following:

- it must be subordinated (i.e., to depositors and general creditors);
- it cannot be secured or guaranteed;
- it must be perpetual, with no incentives to redeem;
- an issuer may be permitted to exercise a call option after five years, subject to prior supervisory authorization and compliance with governance conditions;
- an issuer is only allowed to repay principal, subject to prior supervisory authorization and no repayment expectation should be created for securityholders;
- fully discretionary (i.e., cancelable) non-cumulative dividends;
- no credit-sensitive dividend (e.g., reset) feature;
- no related party purchase or funding of purchase;
- capable of principal loss absorption, through either a conversion into common shares or a write-down mechanism allocating losses to the instrument at pre-specified trigger points;
- no feature which hinders recapitalization (e.g., investor compensation when issuing a new instrument at a lower price); and

- if issued through a special purpose vehicle, the proceeds must be immediately available to an operating entity or holding company in the consolidated group, in a form that satisfies the Tier 1 Additional Going-Concern Capital criteria.

The new definitions and criteria would have the effect of phasing out certain instruments, including instruments with step-up features, cumulative preferred stock, and trust preferred securities. "Innovative capital instruments" also would be phased out over time.

Regulatory Adjustments

The Basel Proposals require regulatory adjustments that are intended to close loopholes. Specifically, the proposed regulatory adjustments, which should be applied to the common equity component of Tier 1 capital, cover the following items, as they tend to compromise the quality of Tier 1 capital:

Type of asset	**Regulatory adjustment**
Stock surplus (i.e., share premium)	Include only if the underlying shares are eligible (e.g., preference shares are excluded)
Minority interest	Not eligible
Unrealized gains and losses	Include only if recognized on the balance sheet
Goodwill and other intangibles	Deduct, net of any associated deferred tax liability
Deferred tax assets	Deduct, net of any associated deferred tax liabilities
Treasury stock (i.e., investment in its own shares)	Deduct (unless already de-recognized under applicable accounting rules)
Investments in certain banks and financial institutions which fall outside the regulatory scope of consolidation	Deduct the same component as would be eligible if issued by the bank itself ("corresponding deduction approach"), as follows: • reciprocal cross-holding agreements or investments in affiliated institutions – deduct in full • all other holdings/investments – subject to a 10% minimum threshold, (i) deduct in full if above 10% of the common shares of the institution in which the bank has invested, and (ii) deduct the amount of excess over the 10% threshold if the aggregate investments in other financial institutions exceed 10% of the bank.
Shortfalls in the stock of provisions relative to expected losses	If under IRB approach, deduct in full (100%). (Cf. Under current rules these are charged 50% to Tier 1 and 50% to Tier 2)
Cash flow hedge reserve	Remove if it relates to cash flows not recognized on balance sheet
Cumulative gains and losses due to changes in own credit risk on fair-valued financial liabilities	Filter out all if fair-valued.
Defined benefit pension fund assets & liabilities	Deduct the assets but apply no filter to the liabilities
All other 50:50 deductions (i.e., items which are currently deducted 50% each from Tier 1 and Tier 2)	Apply a 1250% risk weight, to: • certain securitization exposures; • certain equity exposures under Probability of Default ("PD")/Loss given default ("LGD") approach; • non-payment/delivery on non-delivery against payment ("DvP") and

	non-payment-versus-payment ("PvP") transactions; and • significant investments in commercial entities.

Tier 2 Capital (Gone-Concern Capital)

Tier 3 capital (which used to cover market risk) will be abolished. Tier 2 capital will be simplified by eliminating the distinction between Lower and Upper Tier 2. Tier 2 capital must meet similar criteria as for Tier 1 Additional Going-Concern Capital, i.e., subordinated, neither secured nor guaranteed, prior supervisory consent and other conditions required for the issuer to exercise call option after a minimum of five years, and no credit-sensitive reset feature. Tier 2 capital instruments must:

- have an original maturity of at least five years, to be amortized on a straight-line basis during the final five years to maturity, with no incentives to redeem, and
- not give the investor any right to accelerate repayment (principal or coupon) except in insolvent liquidation.

Disclosure Requirements

Banks will be required to disclose all elements of regulatory capital, including:

- a full reconciliation back to the audited financial statements;
- separate disclosure of all regulatory adjustments;
- a description of the main features of the capital instruments issued (including displaying their terms and conditions on the banks' websites); and
- the ratios involving components of regulatory capital (e.g., "Equity Tier 1", "Core Tier 1" or "Tangible Common Equity" ratios) accompanied by a comprehensive explanation of the ratio calculations.

BCBS continues to review the role that contingent capital instruments may play as part of the minimum capital requirement and as buffers. Concrete proposals on those instruments will be discussed at the July 2010 meeting.

Counterparty Credit Risk

The proposals on the counterparty credit risk ("CCR") arising from banks' derivatives, repo and securities financing activities are rumored to have been a late addition to the consultative document. BCBS recommends changes to the Basel II framework in order to strengthen existing capital requirements and risk management standards for CCR.

CCRs will also be covered in the requirement to build capital buffers and reduce pro-cyclicality. New rules will encourage banks to use central counterparties ("CCPs") for OTC derivatives contracts. Specifically, BCBS makes the following recommendations whereby banks must determine their capital requirement for CCR using stressed inputs:

- Expected Positive Exposure ("EPE") must be calculated on data, including a period of stress, proposed to be based on model parameters calibrated over a three-year period that includes the one-year stressed period used for Stressed Value-at-Risk ("VaR") for credit assets;
- a capital charge for mark-to-market ("MtM") losses (i.e., credit valuation adjustment ("CVA")) to account for deterioration in a counterparty's creditworthiness;

- more rigorous collateral management and margining standards will be introduced, e.g., margining periods will be extended to 20 days for large OTC derivatives and securities financing transactions backed by illiquid collateral;
- zero risk weighting for collateral and MtM exposures to CCPs that comply with enhanced criteria to be published by the Basel Committee on Payment and Settlement Systems ("CPSS") and International Organisation of Securities Commissions ("IOSCO") following their recent review[3] of the 2004 CPSS-IOSCO Recommendations for CCPs, which provide for clearing arrangements for OTC derivatives;[4]
- higher risk weight applying a multiplier of 1.25 to the AVC for exposures to regulated financial firms with assets of at least $25 billion and to all unregulated financial firms (regardless of size);
- various improvements in the calculation of exposure at default ("EAD"), as well as technical enhancements to CCR management requirements, e.g., stress-testing and back-testing requirement;
- a supervisory haircut for all repo-style transactions using securitization collateral and a ban against re-securitizations as eligible financial collateral for regulatory capital purposes; and
- additional constraints on firms' own estimates of Alpha to avoid mis-specification of risk and promote greater consistency among firms.

In addition, BCBS will seek to promote further convergence in the measurement, management and supervision of operational risk and provide incentives to reduce operational risk arising from inadequate margining practices, back-testing and stress-testing.

Leverage Ratio

A new leverage ratio will be introduced. The ratio relates banks' regulatory capital to total balance sheet assets, with a view to possible migration to Pillar 1 treatment. The leverage ratio is designed:

- to constrain the build-up of excessive leverage in the banking system, which compromises loss absorbency, and
- to restrict the overall leverage level (by reinforcing the risk-based capital requirements) with a simple, non-risk based, back-stop measure based on gross exposure.

BCBS is still considering alternative treatments for more complex items, such as securitizations, repurchase agreements, derivatives and off-balance sheet items. Many technical issues remain outstanding. Further work is also pending to harmonize the rules internationally, adjusted for differences in accounting standards.

Pro-cyclicality and Countercyclical Buffers

To reduce pro-cyclicality and promote countercyclical buffers, banks will be required to hold capital buffers over and above the regulatory minimum, with constraints on their ability to make capital distributions and forward-looking provisioning based on expected losses ("EL").

A buffer range is still to be quantified but the capital buffer will be subject to the following key criteria:

- capital comprising the buffer must be based on Tier 1 capital, i.e., able to absorb loss on a going-concern basis;
- capital distribution constraints will apply if capital falls below buffer range;

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[3] CPSS/ IOSCO Recommendations for Central Counterparties (24th November 2004), http://www.bis.org/publ/cpss64.pdf?noframes=1.
[4] *See* BIS press release: CPSS-IOSCO working group on the review of the "Recommendations for Central Counterparties" (20th July 2009), http://www.bis.org/press/p090720.htm.

- forward-looking provisioning (i.e., expected loss approach), to reduce pro-cyclicality, as advocated by the International Accounting Standards Board ("IASB");
- capital conservation rules, i.e., reducing discretionary distribution of earning, such as dividend/coupon payments, share buy-backs, staff bonuses, to build up buffers;
- application of these rules at the consolidated level; and
- additional supervisory discretion to impose appropriate time frames over which individual banks are to build (or re-build) their buffers.

Systemic Risk and Interconnectedness

BCBS is currently reviewing policy options to reduce the probability and impact of failure of systemically important banks. Among other things, BCBS is reviewing: the benefits of a capital surcharge to mitigate the risk posed by systemically important banks, and a liquidity surcharge. Additional refinements to Basel II risk weights are also being considered relating to the treatment of OTC derivatives exposures.

Consultative Document No. 2: International Framework for Liquidity Risk Measurement, Standards and Monitoring

The proposed liquidity rules are seen to be rather prescriptive and tougher than those published by CEBS in its Guidelines on Liquidity Buffers and Survival Periods on December 9, 2009,[5] which banks must start applying by June 30, 2010.

The new liquidity framework involves a set of six standardized metrics, consisting of:

- two liquidity ratios (short-term and longer-term), which will serve as the "regulatory standards" to ensure that banks maintain sufficient liquidity buffers, and
- four monitoring tools by which banking supervisors will track bank liquidity.

Liquidity Ratios

BCBS proposed to adopt two metrics as the "regulatory standards" to be applied by banking supervisors with respect to liquidity risk, a short-term (30-day) ratio and a longer-term (one-year) "structural" ratio based on a bank's funding for its expected portfolio.

Liquidity Coverage Ratio ("LCR")

The LCR is designed to ensure banks maintain 30 days' liquidity to prepare for extreme stress conditions and is an amount of "high quality liquid assets" which will be available to offset against the bank's "net cash outflows" under an acute short-term stress scenario that would involve both institution-specific and systemic shocks, such as:

- a significant credit rating downgrade;
- a loss of deposits;
- a loss of unsecured wholesale funding;
- a significant increase in secured funding haircuts;

[5] CEBS Guidelines on Liquidity Buffers and Survival Periods (9th December 2009), http://www.c-ebs.org/documents/Publications/Standards---Guidelines/2009/Liquidity-Buffers/Guidelines-on-Liquidity-Buffers.aspx.

- increases in derivative collateral calls; and/or
- substantial calls on off-balance sheet exposures (contractual and non-contractual), including committed credit and liquidity facilities.

"High quality liquid assets" are assets that pose low credit and market risk, are easily valued and are liquid. "Liquid assets" include cash, central bank reserves, marketable securities and home state government or central bank debt issued in domestic currencies, certain corporate bonds meeting prescribed eligibility criteria (subject to a 20% or 40% haircut), and certain covered bonds meeting prescribed eligibility criteria (subject to a haircut). Interestingly, BCBS has proposed to prescribe for covered bonds a roughly identical set of eligibility criteria as for corporate bonds, rather than aligning covered bonds with the criteria for government bonds.

Net Stable Funding Ratio ("NSFR")

To capture structural issues related to funding choices and promote longer-term funding of banks' on- and off-balance sheet exposures and capital markets activities, regulatory standards will be introduced on 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 (giving rise potentially to contingent calls on funding liquidity). The NSFR is obtained by dividing the available amount of stable funding by the required amount of stable funding.

Monitoring Tools

In addition to the "regulatory standards" described above, BCBS also proposed that supervisors use "monitoring tools" comprising four additional metrics.

Contractual Maturity Mismatch

This metric tracks a bank's cash and security inflows and outflows from all on- and off-balance sheet items, mapped to defined time bands to be set by supervisors (e.g., overnight, 7-day, 14-day, 1, 2, 3 and 6 months, 1, 3, 5 and 5+ years) based on their respective maturities. This metric is meant to help identify the gaps between contractual inflows and outflows of liquidity and, in turn, the bank's potential capital raising needs.

Funding Concentration

This metric helps identify important funding sources, the withdrawal of which could trigger liquidity problems. To this end, the metric involves monitoring a bank's funding liabilities according to:

- each significant counterparty (or group of connected or affiliated counterparties, as defined under the "large exposure" regulation) (i.e., having more than 1% of its total liabilities in aggregate),
- each significant product or instrument (i.e., amounting to more than 1% of its total liabilities in aggregate), and
- each significant currency (i.e., liabilities denominated in a single currency amounting to more than 1% of the bank's total liabilities in aggregate).

The relevant data should be reported for time bands of 1 month, 1-3 months, 3-6 months, 6-12 months and 12+ months.

Available Unencumbered Assets

This metric monitors the amount and characteristics of a bank's unencumbered assets, which could be used as collateral for secured funding in secondary markets or central bank standing facilities, thereby providing additional liquidity.

Market-Related Monitoring Tools

The following market data—both for the financial sector as a whole and for the specific bank—should be monitored so as to provide early warning indicators of potential liquidity difficulties:

- Market-wide information;
- Information on the financial sector; and
- Bank-specific information.

Application Issues

Reporting should be at least monthly, but the supervisor may require weekly or even daily reports in a stress period. The new requirements should be applied to all international banks on a consolidated basis.

Currencies of the Liquid Assets Pool

These currencies should be similar in composition to the bank's operational needs to ensure transferability in a stress situation.

Public Disclosure

These disclosure requirements will be similar to those of capital positions.

Conclusion

So, how do you like it? The Basel Proposals present a significant series of changes that would have far-reaching impact on financial institutions. It is fair to assume that as market participants continue to digest the proposed changes, there will be comments. Analysis of the Basel Proposals may be further complicated by the fact that within almost every jurisdiction, local regulators are busily working to advance legislative changes that would impact some of the same areas. For example, in the U.S., debate continues regarding regulation of the OTC derivatives market. Until some of the major pieces of regulatory reform come together, it will not be possible to ascertain how all of the elements will work together.

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