Financial Services Management

Basel III Capital Requirements

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Overview

The Basel Committee has finalized the new Basel III capital framework for global banking organizations, setting in motion a process in which national jurisdictions like the United States will need to implement changes that will significantly increase the quality and quantity of regulatory capital banks must hold, as well as hike capital requirements for counterparty exposures, reduce reliance on credit rating agencies, impose new capital "buffers" to conserve capital under stress and provide a counter-cyclical incentive. One of the key features in the Basel III capital rules is a new leverage standard. This will impose a minimum capital charge for most on- and off-balance sheet assets, setting a supervisory floor for regulatory capital to supplement the risk-based standards and limiting the adverse impact of model or measurement failures. However, reflecting the cost of the leverage standard (especially outside the U.S.), it will be gradually phased in and form only a part of Pillar 2 (supervisory) capital, not mandatory Pillar 1 requirements unless or until the Basel Committee revises this treatment.

In sum, the Basel III capital standards will sharply increase regulatory capital, although the final rules will phase this in so that banks can to the greatest degree possible meet the standards through retained earnings, not new capital and/or reductions in assets. Still, most covered banking organizations will need to raise significant amounts of capital through one of these strategies, with the industry and the Basel Committee differing only on the relative scale of these increases and the degree to which they will have adverse macroeconomic results. There seems little doubt that significant, adverse profit implications and strategic changes within banking organization business lines will result as Basel III is implemented.

Impact

The final Basel III capital rules follow a December, 2009 consultative paper.[1] The rules come in tandem with central counterparty-related capital proposals, significant changes to global liquidity requirements,[2] continuing work to designate systemic institutions and then regulate them,[3] and work to improve cross-border resolution of large, complex institutions.[4] At the same time, the Committee has completed parts of the "Basel II.5" framework, issuing in late 2009 new standards for resecuritizations[5] and market-risk.[6]

Below, key implications of the Basel III Capital Accord are assessed:

Capital Quality and Amount

These Basel III provisions are the most certain and costly. They reflect the consensus of global regulators that Basel II permitted too much models deference, too little reliance on tangible equity and, overall, insufficient capital safeguards to ensure that market participants, not taxpayers, take risk. As noted, this aspect of Basel III will require significant changes in capital levels, revisions softened by the extended transition periods but not substantially alleviated by them. Thus, virtually all covered banking organizations will need to consider the details of the new rules, including the changed risk weightings and leverage requirements discussed below, determining how much additional capital of what type is necessary to support activities that provide the most attractive risk-adjusted return on capital under Basel III.

The increases in regulatory capital and the forced reliance on more expensive forms of capital will dampen return on equity at most banking organizations, although regulators anticipate that greater investor confidence will to some degree offset this adverse profit impact due to reductions in the

[1] See Client Reports **CAPITAL157-161**.

[2] Forthcoming analyses of all of these rules will shortly be provided in FedFin FSM Reports for clients.

[3] See Client Report **SYSTEMIC36**, *Financial Services Management*, November 23, 2010.

[4] See Client Report **SYSTEMIC14**, *Financial Services Management*, October 23, 2009.

[5] See Client Report **CAPITAL151**, *Financial Services Management*, July 23, 2009.

[6] See Client Report **CAPITAL152**, *Financial Services Management*, August 25, 2009.

cost of capital. The industry has argued, supported by some research, that higher capital requirements will dampen credit availability and undermine economic recovery, but regulators made clear in releasing Basel III that they discount this.

The new focus on tangible common equity (TCE) will dramatically reduce the degree to which other instruments count as Tier 1 capital, the most important component under Basel III. Banks with significant affiliates will need to raise more TCE to offset dramatic reductions in the capital value of their minority interests. In general, capital volatility will increase because banks will now need to recognize unrealized gains and losses, possibly forcing significantly greater capital commitments under stress conditions. U.S. banks with significant holdings of mortgage servicing rights will need to replace them with TCE or other eligible Tier 1 capital, possibly leading to a major shift away from mortgage-securitization operations and related servicing activity.

Risk Weightings

In general, Basel III does not change the risk weightings assigned under Basel II. As a result, instruments that have shown themselves riskier in the current crisis (e.g., sovereign debt and certain mortgage instruments) will generally not be subject to higher capital, occasioning some criticism of the final standards. However, national regulators remain free to assign higher risk weightings as desired, possibly leading to more stringent requirements in some countries. This is particularly likely in the U.S. due to the mandatory prohibition on ratings-agency reliance (see below).

However, while most risk weightings remain unchanged, aspects of the process of assigning weightings has been revised in the new rules. This is particularly true with regard to counterparty credit risk (CCR), where stringent new requirements for certain investment products have been imposed. Among the most important of these is a new "credit value adjustment," which will require capital recognition not just of the probability of default – previously addressed in Basel II – but also of asset-value reductions related to market fears of adverse credit events. This incorporates mark-to-market assessments in capital determinations even where not otherwise required by accounting or regulatory standards and could force significant capital cost and/or volatility under adverse market conditions. However, it will also offset the "cliff effect" of sudden market shocks like ratings downgrades, as banks will have needed in advance to adjust capital requirements as problems begin to surface through market-pricing drops.

In addition, the rules, while less stringent than initially proposed, still sharply increase the regulatory capital required for exposures to the largest financial institutions. These provisions are intended to reduce systemic risk by hiking regulatory capital related to large exposures to entities that themselves may pose systemic risk. Banks will need to consider their CCR and large-bank exposures to identify those that warrant continuation under the tougher new capital rules, as well as ensure that more stringent internal-control requirements in these areas are met. Significant investments in stress-testing, back-testing and independent risk management may be required, along with a heightened role by the board and senior management in setting the bank's risk appetite in these arenas.

Capital Conservation Buffer

In addition to the tough new capital quality and quantity requirements noted above, the Basel III standards impose a capital conservation buffer of 2.5 percent above minimum requirements. Although the rules state that this is not intended to be a new, supra-minimum charge, a table makes clear that higher capital is required whenever banks fall below the buffer. This capital is to come either through reduced distributions (e.g., lower dividends, reduced share buy-backs or curtailed bonuses) or through new capital flows. The charge is intended to prevent a phenomenon observed in the crisis, where stressed banks continued capital distributions out of concern that limits would adversely affect their competitive position or spook investors. Due to these capital depletions, these banks were even more ill-prepared to withstand stress. However, if the conservation buffer is in fact a new minimum, then banks may have particular difficulty raising new capital when they fall below it out of investor fears of scant dividends and qualified new management may also be difficult to attract when banks are below the buffer.

This buffer poses particular concern in the U.S. where "prompt corrective action" (PCA) requirements mandate sanctions when banks are less than well- or adequately-capitalized, with these requirements significantly toughened in the Dodd-Frank Act.[7] Until the status of this buffer and the counter-cyclical one (see below) are clarified, U.S. banks could be subject to multiple capital thresholds and sanctions not otherwise applicable to global banking organizations.

Counter-Cyclical Capital

The final Basel III rules include a standard proposed towards the end of the negotiations process.[8] The rules permit national authorities to impose yet another buffer of 2.5 percent above the new Pillar 1 minimums, this time if "excessive" credit growth in comparison to gross domestic product (GDP) warrants intervention. This charge may not be imposed if a single sector (e.g., mortgages) is problematic and it is unclear how national regulators will in fact implement it due to the general nature of the trigger event. It is intended to address any procyclical capital incentives left in Basel III after all the stress-testing and other provisions in the standards, although its impact on

[7] See Client Report **FHC19**, *Financial Services Management*, July 29, 2010.

[8] See Client Report **CAPITAL166**, *Financial Services Management*, August 10, 2010.

credit availability, economic recovery for nations beginning to experience stress and cross-border banks is at best uncertain.

Leverage

As noted, one of the most significant changes in Basel III is a new leverage requirement. Reflecting the major cost impact this will have on banks outside the U.S., the rules phase in the leverage standard and leave open the degree to which it will ultimately form part of mandatory minimum requirements, although the plan is to have it do so on January 1, 2018. The proposed leverage ratio is set at three percent, which banks will need to reflect in disclosures, if not actual capital, by 2015.

Arguably, this standard will pose no burden for U.S. banking organizations, which have long been subject to leverage requirements set at five percent for well-capitalized institutions. However, the U.S. standards apply only to on-balance sheet assets. Regulators have decided now to go beyond this in the global rules on grounds that off-balance sheet risk (e.g., that in structured investment vehicles) poses serious risks and that leverage rules should not create arbitrage incentives to hold assets off-balance sheet. Large U.S. banking organizations are particularly active in products where off-balance sheet positions are common, suggesting that the global leverage standards could still pose a new burden for them.

Disclosure

Pillar 3 – disclosure – provisions of the Basel standards are also revised. Following guidance in 2011, significantly more transparency will be mandated for factors such as the degree to which non-compliant capital instruments still count towards Pillar 1 minimum requirements and the manner in which regulatory capital comports with balance-sheet accounting statements. This will permit investors better to assess the composition of bank capital and the degree to which strain may ensue as full Basel III compliance comes into effect. However, these requirements could also pose securities-law and other concerns for covered institutions.

What's Next

The Basel Committee released the final Basel III standards on December 16, 2010 following years of debate and considerable controversy among member nations. Participating nations are to issue their implementing rules in 2011 with effective dates of January 1, 2013. However, certain aspects of the rules have transition periods discussed below, meaning that the full force of the Basel III capital rules will not be felt until 2019. Aspects of the standards have been issued even though specific rules (e.g., for new Pillar 3 disclosures) are pending for issuance in 2011 and other provisions (e.g., leverage, counterparty capital) remain under review and subject to potential substantive revision.

The U.S. has committed to implement Basel III despite its inability to do so for Basel II. The Basel II.5 rules are being proposed now[9] and U.S. regulators plan to issue initial Basel III proposals by mid-2011 to ensure compliance with the final deadlines noted above. However, Basel III is already a *de facto* requirement for the nation's very largest banking organizations following the FRB's decision in late 2010 to stress-test these firms to ensure their readiness for the new rules.[10]

Further, the U.S. also has its own set of regulatory-capital standards required by the Dodd-Frank Act[11], some of which will complicate implementation of Basel III. These include provisions in the "Collins Amendment"[12] that some may see as forcing foreign firms operating in the U.S. to hold more capital than Basel III in a manner beyond that allowed by national discretion within the Accord. The Dodd-Frank Act[13] also bars use of ratings in all U.S. rules, including capital standards. The U.S. regulators have begun to consider how this can be done,[14] but remain uncertain as to alternative measures of credit risk. This will further complicate U.S. implementation of Basel III which, while reducing ratings reliance, still incorporates them into risk weightings.

The U.S. law also mandates a systemic-risk surcharge and other requirements that may differ considerably from global requirements. U.S. law also requires that banks meet the PCA requirements noted above that impose sanctions when various capital thresholds are missed. It is unclear how the Basel III rules, especially the conservation requirements, will comport with PCA.

Analysis

The following analysis is a guide to strategic issues in the Basel III capital requirements. Clients are directed to the detailed rules for implementation considerations.

9 Forthcoming FSM Reports.

10 See Client Report **STRESS5**, Financial Services Management, November 29, 2010.

11 See Client Report **CAPITAL162**, June 29, 2010.

12 See Client Report **CAPITAL172**, Financial Services Management, December 21, 2010.

13 See Client Report **RATINGS37**, Financial Services Management, August 9, 2010.

14 See Client Report **RATINGS38**, Financial Services Management, August 24, 2010.

I. Capital Quality and Amount

In addition to the changes noted below, the Basel Committee continues to consider the need for contingent-capital requirements.

A. Capital Elements

Capital will consist of the sum of the following elements and must equal at least eight percent of risk weighted assets (RWAs). Certain holdings must be deducted from capital and, now, this must be done through each tier of capital until the deduction is completed if a bank lacks sufficient capital in one of the tiers for compliance. Certain holdings that were deducted proportionately from Tiers 1 and 2 under Basel II (e.g., certain securitization and equity exposures, investments in non-financial entities) now must be backed with capital against a 1,250 percent weighting.

1. Tier 1 (Going-Concern) Capital

Upon full implementation of Basel III in 2015 (for this portion of the rules), common equity Tier 1 must be at least 4.5 percent of risk-weighted assets and all Tier 1 must be at least six percent of RWAs. Common equity Tier 1 consists of:

- common shares and related premiums that meet specified criteria;
- retained earnings;
- accumulated comprehensive income and other disclosed reserves. Unrealized gains and losses do not count, although a transitional period is provided for deletion of unrealized loss; and
- minority interests that are consolidated with the banking organization in financial companies subject to limits discussed below.

The residue of Tier 1 capital consists of elements that meet specified criteria (e.g., fully paid-in, subordinated to other creditors, unguaranteed by affiliates, subject only to limited call rights, no “dividend-pushers,” etc.), including:

- mortgage servicing rights;
- certain deferred tax assets; and
- significant investments that are not consolidated with the parent in financial companies.

No more than fifteen percent of common equity can be held in the instruments listed above until January 1, 2018, when all must be deducted. The rules include a phase-

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out schedule over this period. Holdings above this amount are subject to a 250 percent weighting.

2. Tier 2 (Gone-Concern) Capital

Eligible instruments here include a limited amount of the allowance for loan and lease losses (up to 1.25 percent RWAs calculated with regard to credit risk under the standardized approach) or 0.6 percent under the internal-ratings based (IRB) approach (with national discretion permitted to set a lower threshold related to the IRB).

3. Non-Compliant Instruments

The standards also include a phase-out for certain instruments now counted as Tier 1 or Tier 2 capital issued before September 12, 2010 that no longer comply, beginning in 2013.

B. Minority Interests

Minority capital interests count for common equity Tier 1 only if they otherwise meet all of the relevant eligibility criteria and the subsidiary issuing the shares is itself a bank. Otherwise, the rules require deduction from capital for minority interests in banks or other financial firms that are consolidated with that of the parent holding company, with limited exceptions possible under national discretion for investments in distressed banks.

C. Disclosures

New disclosures are required of:

- a full reconciliation of all capital elements to the balance sheet;
- all regulatory adjustments and items not deducted from Tier 1 common equity under the grandfather noted above for MSRs and similar instruments;
- a description of all limits and minimum requirements, identifying positive and negative elements; and
- the main features of issued capital instruments, including their full terms and conditions.

As noted, disclosure guidance will be provided in 2011.

II. Risk Coverage

A. Counterparty Credit Risk

These provisions are effective January 1, 2013. A new stress calibration and related qualitative standards are required for advanced banks using internal models to assess counterparty risk for long settlement transactions, securities financing transactions, and margin lending transactions. These will bring the treatment of counterparties into closer compliance for the banking book with the new, tougher stress requirements in the revised market-risk rules referenced above.

The final standards also tighten the requirements for reliance on internal models, stipulating eligibility criteria, back-testing requirements and similar matters. Regular reports to senior management on stress-tests and model performance are mandated and senior management must ensure that stress-test findings are incorporated into proactive management of counterparty credit risk. The individual responsible for internal models in this area must be independent of business units and report directly to senior management. In addition, a credit value adjustment is now required to reflect market factors even if these are not otherwise reflected in the bank's books. Capital here must be held against a portfolio as a whole, not just for individual exposures based on stipulated model factors. Supervisors could adjust the stress calibrations if deemed appropriate.

In addition, new charges apply for exposures to OTC derivatives and other instruments of certain counterparties (excluding certain central counterparty or securities financing, unless required by supervisors). A complex formula for doing so is included in the rules to reflect market-implied default probability. Doing so in part relies on value-at-risk (VaR) models, although these charges are in addition to any applicable under the market-risk rules noted above. Only hedges expressly used for credit-value-adjustment risk can offset this new capital charge, and all such instruments must be single-name or fall within a limited group of index CDS. A portfolio capital charge based in large part on external ratings for credit value adjustments is detailed for banks without approval for internal-model reliance. An impact assessment of this new charge is scheduled for completion in the first quarter of 2011.

B. Wrong-Way Risk

Stress-testing and scenario analysis must identify counterparties with significant wrong-way risk (i.e., market factors positively correlated with counterparty creditworthiness). This should be done by product, region, industry and other categories, providing reports to senior management and board committees. In addition, a new Pillar 1 charge for wrong-way risk is imposed, with calculations here required for all legal entities to which a bank is exposed as well as to groups.

C. Asset Correlation for Large Financial Institutions

This factor is increased to heighten the Pillar 1 capital for counterparty exposures to large financial institutions (i.e., regulated financial companies with assets over $100 billion). A higher asset correlation multiplier is applied to unregulated financial companies.

D. Collateral and Margining

Rules here are also significantly tightened. Banks with large and illiquid derivative exposures to a counterparty will have to apply longer margining periods as a basis for determining regulatory-capital requirements. Additional standards strengthen collateral risk-management practices (e.g., through required independence for a collateral-management unit that must assess valuations daily and monitor collateral reuse). The rules also call for new measures to address the liquidity risk associated with collateral calls on the bank itself, despite the fact that this is also addressed in the liquidity rules accompanying the Basel III capital standards.

E. Credit Rating Agency (CRA) Reliance

1. Overall Standards

In general, the new standards seek to reduce reliance on CRAs without expressly mandating alternative measures of creditworthiness. Banks may rely on CRAs only if they comply with global CRA standards, with national supervisors required to ensure that this is the case before permitting weights to rely on a CRA. They are to do so through published standards that meet criteria stipulated in the final Basel III standards. Banks must use CRAs consistently both for risk weightings and risk management, and they are barred from cherry-picking ratings to set capital. In general, only solicited ratings are to be used.

2. Credit Risk

Under the standardized approach, which previously was directly ratings-dependent, banks are to assess the relative rating of an obligor and compare it to other risks, especially those for unrelated obligations, to determine the applicable risk weighting. Further, ratings cannot be used to infer risk weightings on unrated obligations. Banks must assess all exposures on their own to prevent incentives to hold unrated assets to avoid punitive, ratings-based weightings. More sophisticated banks should assess creditworthiness through:

- a risk-rating system;
- portfolio analysis/aggregation;
- securitization/complex credit derivatives; and
- large exposures and risk concentrations.

3. Operational Requirements

The rules also stipulate operational standards for CRA reliance by banks that use both the standardized and advanced methods. These reinforce the need to rely only on CRAs that meet supervisory standards.

4. Eligible Guarantors

To address the “cliff effect” that can create systemic risk due to sudden market-price and credit-availability reductions following ratings downgrades, the final standards change the way risk weightings are set for guarantors. For sovereign entities, public-sector entities (PSEs), banks and securities firms, a guarantee may be recognized for a reduced risk weighting if the guarantor has a lower risk weight than the counterparty (set either through the rating or the methods discussed above). Other guarantors may also be recognized, but this is to be based on their external rating (except for securitization guarantees). “Other guarantors” may include parent firms and affiliates if they have a lower risk weighting than the counterparty and are externally rated. For securitization exposures, a guarantor other than a sovereign, PSE, bank or securities firm must be rated A- or better when the credit protection is provided. Credit protection will not be recognized if the guarantor’s rating falls below BBB.

III. Capital Conservation Buffer

This buffer will be phased in, beginning on January 1, 2016 to year-end, 2018. A schedule for building to the framework described below is provided. Countries with “excessive” credit growth are directed to consider earlier implementation of the buffer and new counter-cyclical charge.

A. Best Practice

Outside of periods of stress, banks should hold buffers of capital above the regulatory minimum. When buffers have been drawn down, one way banks should look to rebuild them is through reducing discretionary distributions of earnings (e.g., reductions in dividends, bonuses). Alternatively, capital may be raised, with the balance between these options to be discussed with supervisors. In the absence of new capital, capital distributions should be reduced proportionately to rebuilding of the capital buffer. A bank with a depleted buffer is generally barred from capital distributions.

B. Framework

This framework should be applied at the consolidated level, but national regulators may impose it on individual units to conserve resources within a group. A capital conservation buffer of 2.5%, comprised of common equity Tier 1, is established above the regulatory minimum capital requirement. No constraints are imposed when a bank falls below this threshold *per se*, but capital distributions or increases must be adjusted to rebuild the buffer. The buffer is not intended as a new minimum requirement, but the rules include a table showing the percentage of earnings that need to be retained when Tier 1 common equity begins to falter. Common equity Tier 1 must first be used to meet the minimum capital requirements (including the 6% Tier 1 and 8% total capital requirements, if necessary), before the remainder can contribute to the capital conservation buffer.

C. Supervisory Discretion

In addition to discretion to determine where the buffer applies, supervisors may impose time limits on buffer rebuilding to prevent banks from gaining competitive advantage by routinely operating within their buffers. National regulators may also impose shorter transition periods than those noted above.

IV. Counter-Cyclical Buffer

This charge will be phased in on the same transition schedule as the conservation buffer. Should a nation impose a higher counter-cyclical buffer than provided under the transition period or governed by the final framework, national reciprocity provisions charging it on internationally-active banks would not apply.

A. National Buffers

This charge is to be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses. The Basel Committee has issued principles for national authorities to guide them in determining when this charge is to be imposed.

Jurisdictions are to announce their decision to add the counter-cyclical buffer up to twelve months before imposing one, but buffers may be immediately released. The counter-cyclical charge may vary from zero to 2.5 percent. This focus on excess aggregate credit growth means that jurisdictions are likely to only need to deploy the buffer on an infrequent basis. The buffer for internationally-active banks will be a weighted average of the buffers deployed across all the jurisdictions to which they have credit exposures. This means that they will likely find themselves subject to a small buffer on a more frequent basis, since credit cycles are not always highly correlated across jurisdictions.

B. Bank-Specific Buffers

When national buffers are invoked, banks are to comply with them in the manner stipulated for the conservation buffer (i.e., generally at the consolidated level and are subject to limitations on capital distributions if buffers are transgressed). The Basel Committee continues to consider new loss-absorbing capital options,[15] but will require that the counter-cyclical buffer be held in common equity Tier 1 until any alternative is decided.

[15] See Client Report **CAPITAL168**, September 8, 2010.

V. Leverage Ratio

A. Implementation

The Committee plans an initial leverage ratio of three percent housed in Pillar 2 during the parallel run from January 1, 2013 to January 1, 2017. The transition to this begins on January 1, 2011, when the overall regulatory concept of the leverage standard as proposed will be assessed over different business cycles and product lines, also taking into account evolving accounting standards. Bank disclosure of leverage capital would commence January 1, 2015, with the specifics to be determined once these transition periods are under way.

B. Calculation

The leverage requirement is based on the average of the monthly leverage ratio over the quarter based on the new definitions of Tier 1 capital and total exposure (generally measured according to applicable accounting rules). Items deducted from capital will also be deducted from exposure. During the parallel run, the Committee will consider using a total capital ratio for the leverage standard. The leverage standard will finally be implemented in the first half of 2017, with the goal of "migrating" it to a Pillar 1 charge on January 1, 2018.

Key aspects of the exposure measure include:

- deduction of specific provisions and the CVA;
- lack of recognition of collateral, guarantees or credit risk mitigation;
- disallowance of netting of loans and deposits;
- a specific measure for securities financing detailed in the standards and a similar charge for derivatives (where exposure is generally equated to a loan-equivalent amount); and
- inclusion of off-balance sheet instruments, treated with a credit conversion factor of 100 percent unless subject to unconditional cancellation by the bank without prior notice (when a ten percent CCF applies, although this treatment remains under review to ensure it is sufficiently stringent).

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