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INTERNATIONAL BANKING

Expert Analysis

Paying Attention to Proposed Capital and Liquidity Requirements

By
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In my September 2009 column, I discussed the issuance by the Basel Committee of the Bank for International Settlements (Basel Committee) of a set of guiding principles and measures to enhance capital standards and other improvements aimed at the global economy.[1]

The Basel Committee now has come back with more specific proposals to strengthen global capital and liquidity requirements for banks. These proposals, issued in mid-December of 2009, are open for comment until April 16, and likely will be finalized by the end of this year.[2] This month's column will focus on three key proposals: a new definition of regulatory capital, the imposition of a leverage ratio and the establishment of a specific liquidity ratio requirement.

Why Care Now?

Internationally active banks should review these documents and consider submitting comments by April 16. Even though the final consultative document does not have the force of law, any final proposals that are adopted become the standard to be adopted by each country. Adoption of the proposals in their current form could result in an immediate reduction in capital levels for a bank. Even though senior officials of banks may feel it is better to fight this type of battle with their own home country regulators, I would urge they consider submitting comments now before the standards are set and may be hard to change.

These two consultative documents, "Strengthening the resilience of the banking sector" ("Resilience Proposals") and "International framework for liquidity risk measurement, standards and monitoring" ("Liquidity Proposals") are part of an attempt by global organizations such as the Basel Committee and the Group of Twenty (the G-20, made up of representatives of industrialized and developing countries) to promote a more robust banking sector that can better weather the next international economic crisis when it comes.[3]

Regulatory Capital Definition

One of the proposals is to change the definition of capital, primarily with respect to Tier 1 (core) capital, to make sure that common equity is the predominant component of Tier 1 capital. Tier 1 capital must be able to absorb losses while enabling the bank to keep functioning.

Common Equity

To be considered common equity, the instruments must be common shares, and the drafters have set forth 14 mandatory elements that must be met for the instrument to be considered common equity and eligible for Tier 1 treatment, including that the instrument must represent the most subordinated claim in liquidation of the bank, be directly issued and paid up, and take the first hit of any losses that may occur.

In addition, the shares may not be repaid outside of liquidation and in that event, shareholders will be entitled to a claim on residual assets only after all senior claims have been paid. Further, the paid-in amount must be classified as equity under relevant accounting standards and recognized as equity capital for determining balance sheet insolvency.

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Other Tier 1 Instruments

Other instruments also may qualify as Tier 1 capital, provided that common equity remains the predominant element. Such instruments must be able to bear losses when the bank remains a going concern, and any payments on the instrument must be discretionary. Some of the same criteria for common equity also will apply to other instruments eligible as Tier 1 capital, such as having to be issued and paid-in, unsecured, and perpetual with no incentives to redeem.

Additional criteria include subordination of the instrument to depositors, general creditors and subordinated debt of the bank, being callable only after a minimum of five years with the approval of the supervisor, and having no ability for periodic re-set of dividends according to the bank's credit rating. Proposed adjustments to Tier 1 include a prohibition on removing unrealized gains or losses from the common equity component of Tier 1 capital and a requirement of deductions from the common equity component of Tier 1 capital for goodwill and certain other intangibles.

Tier 2 Capital

Specific criteria for an instrument's inclusion in Tier 2 capital include many of the same features as for Tier 1 capital, such as instruments that are issued, paid-in, unsecured and subordinated to depositors and general creditors of the bank (but they need not be subordinated to the subordinated debt as is required for Tier 1 capital). Instruments must have a minimum original maturity of at least five years, and there are restrictions on the ability of the bank to call the instrument.

One of the issues on which the Basel Committee would like specific comment is whether there should be some sort of locking mechanism for Tier 2 capital instruments to ensure they do not need to be repaid during a period of stress.

Tier 3 Capital

Tier 3 capital, which was used to cover market risks, will be eliminated. The theory behind elimination is that market risks should be met with the same quality of capital as credit and operational risks.

Leverage Ratio

Internationally active banks in the United States have complained for years about the requirement that they maintain a leverage ratio (a ratio of Tier 1 capital to average total consolidated assets) while other internationally active banks outside the United States were not required to do so.[4] That is about to change. Imposition of the leverage ratio was one of the proposals adopted by the G-20 at its September 2009 Pittsburgh Summit and discussed in my September 2009 column. In the drafters' opinions, imposing a leverage ratio will limit the build-up of leverage in the banking sector (which they saw as a feature of this past crisis) and reinforce the risk-based requirements

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with a non-risk based backstop.

The definition of capital to be used in calculating the leverage ratio will be the same as that proposed for the risk-based definition of capital. In looking at the assets against which the Tier 1 capital will be compared, total exposure would be net of provisions and valuation adjustments, and physical or financial collateral will not be allowed to reduce exposure. Netting will be disallowed, including netting of derivatives, repo style transactions and loans against deposits.

Included in the assets would be all items on the balance sheet, including high-quality liquid assets and repo style transactions with no netting. For securitizations, either retained positions or the underlying securitized portfolio will be required to be included, depending on whether the securitization meets certain criteria.

While not setting forth a proposed specific ratio, the drafters offer some options for commenters to review and consider. For banks that never have had to face this requirement before, depending upon its business activities, there could be a shortfall which would require that additional Tier 1 capital (primarily common equity) promptly be enhanced to meet the requirement. The aim is to reach an internationally harmonized standard that fully adjusts for material differences in accounting and will appropriately integrate off-balance sheet items that also were a major source of leverage in this last crisis.

Liquidity Proposals

In September 2008, the Basel Committee issued "Principles for Sound Liquidity Risk Management and Supervision" to address the ineffective management of liquidity risk that occurred during the last economic crisis. Building on that document, the Liquidity Proposals recommend adoption of two internationally consistent standards for liquidity risk supervision: the Liquidity Coverage Ratio to promote short-term resiliency of the liquidity risk profile of banks and the Net Stable Funding (NSF) Ratio to promote resiliency over longer term time horizons.

Liquidity Coverage Ratio

The objective of the Liquidity Coverage Ratio is to ensure that the bank has sufficient liquid assets which should enable the bank to survive until day 30 of a proposed stress scenario. Thirty days of estimated net cumulative cash outflows must be covered by at least 100 percent of high-quality liquid assets on a continuous basis.

The Basel Committee proposes a very specific stress scenario against which to test the liquidity ratio, involving material downgrade in a bank's credit rating, loss of a portion of the bank's retail deposits, unscheduled draws on the bank's unused credit facilities and increases in market volatilities that impact the quality of collateral or potential future exposure of derivative positions. The objective was to consolidate various stress scenarios from the economic crisis into one scenario for which liquidity is needed to survive up to 30 calendar days.

This proposed stress test is seen as the minimum supervisory requirement; banks would be expected to conduct their own stress tests to assess the level of liquidity they should hold beyond this minimum, construct scenarios that could cause difficulties for their specific business activities, and utilize longer time periods than the 30 days required under the Liquidity Coverage Ratio.

The Basel Committee's proposed definition of "high quality liquid assets" includes cash and marketable securities representing claims on the U.S. government, sovereigns and certain international organizations that, among other criteria, are assigned a 0 percent risk-weight under the revised Basel II standardized regulatory capital guidelines. As to which instruments to classify as high quality liquid assets, the fundamental characteristics would include low credit and market risk, ease and certainty of valuation, low correlation with risky assets, listing on a developed and recognized exchange market for which there is an active and sizable market, and easy convertibility to cash. For example, the Basel Committee is considering including certain low credit risk bonds at current market value, but for no more than 50 percent of the total amount of assets.

As for the cash outflows (after first netting out expected cash inflows during the time period of the stress scenario) against which the high-quality liquid assets would act as a buffer, the Basel Committee would include retail (natural person) deposit run-off and secured and unsecured wholesale funding run-off. Additional requirements would be adopted for derivative transactions, draws on committed loan facilities and other contingent funding liabilities.

NSF Ratio

The NSF Ratio would complement the Liquidity Coverage ratio standard and provide an incentive for a bank to make structural changes in its liquidity risk profile that would provide for more stable, long-term funding of assets and business activities.

The NSF Ratio is defined as the ratio of the available amount of stable funding against a required amount of stable funding, with the ratio always being greater than 100 percent. Available stable funding is the sum of a bank's capital, preferred stock with a maturity of equal to or greater than one year, liabilities with effective maturities of one year or greater and, with a haircut, a portion of certain deposits that would not run off over an extended period of time in a stress event.

Required stable funding is the sum of the value of the assets held and funded by the bank, multiplied by a specific required stable funding (RSF) factor assigned to each particular asset type. Added to that would be off-balance sheet activity (or other potential liquidity exposure) multiplied by its associated RSF factor.

The RSF factor applied to the reported values of each asset or off-balance sheet exposure is the amount of that item that supervisors believe should be supported with stable funding. The more liquid the asset, the lower the RSF factor. RSF factors start at 0 percent for cash and money market instruments and go up to 100 percent. For example, unencumbered marketable securities with maturities of equal to or less than one year would have an RSF factor of 5 percent, while gold would have an RSF factor of 50 percent and loans to retail clients having a residual maturity of less than one year would have an RSF factor of 85 percent. In addition, RSF factors will be assigned to certain off-balance sheet items such as contingent funding and letters of credit and guarantees.

Conclusion

As I have noted in various columns over the past year, banks have to realize that there is going to be change and there are going to be stricter capital and liquidity requirements, particularly for internationally active banks that could pose a more global systemic risk. For such a bank, if a pro forma calculation under the proposed standards reveals that the bank would have materially lower capital and liquidity, serious consideration should be given to submitting a comment to the Basel Committee that clearly describes the practical effect of the proposal and offers recommendations on what changes could be made to continue furthering the purpose of more global stability while at the same time not causing banks to incur substantial compliance costs. Whatever comes out of the Basel Committee will be the default that will be expected to be the standard. Commenting now could be a bank's best chance for influencing that standard.

1. "Will Strengthening Capital Standards Forestall the Next Banking Crisis?" New York Law Journal, Sept. 16, 2009.
2. Consultative Documents "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring" issued Dec. 17, 2009, by the Bank for International Settlement (BIS), Basel Committee on Banking Supervision. These documents are available through BIS Web site at http://www.bis.org.
3. These proposals also would be applicable to both banks and bank holding companies, but I will use the term "bank" in this column to include bank holding companies.
4. See, for example,12 CFR §208.43.