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INTERNATIONAL BANKING

Expert Analysis

New International Capital And Liquidity Requirements

By
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In December 2009, the Basel Committee issued proposals to strengthen capital and liquidity standards for banks and to ensure a more resilient banking sector.[1] Almost exactly one year later, in December 2010, the Basel Committee issued a series of documents with the text of the rules.[2] This month's column will highlight a few of the specific capital and liquidity requirements that banks' home countries will be required to adopt.

Regulatory Capital

As with the December 2009 proposal, the December 2010 rules require changes in the calculation of Tier 1 and Tier 2 capital, and initiate the calculation of a leverage ratio.

Tier 1 Capital has two elements: Common Equity Tier 1 and Additional Tier 1.

Common Equity Tier 1 consists of the sum of (i) common shares that meet the 14 criteria as described in the December 2009 proposal (including that it represents the most subordinated claim in liquidation of the bank, and is the issued capital that takes the first and proportionately greatest share of any losses as they occur); (ii) stock surplus resulting from the issue of instruments included as Common Equity Tier 1; (iii) retained earnings; (iv) accumulated other comprehensive income and other disclosed reserves; (v) common shares issued by consolidated subsidiaries and held by third parties that meet the criteria for inclusion in Common Equity Tier 1; and (vi) certain regulatory adjustments.

Additional Tier 1 capital. The predominant form of Tier 1 capital will be required to be common shares and retained earnings. Nonetheless, there will be additional instruments that will be permitted to be counted as Tier 1 capital that are issued and paid-in, perpetual, fully subordinated, and meet certain other criteria, including that the instrument has no dividends or coupons that periodically reset based on the bank's credit rating. Stock surplus not eligible for inclusion in Common Equity Tier 1 will only be able to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital.

The criteria for eligibility as Tier 2 capital instruments resemble many of the Additional Tier 1 capital instruments except that Tier 2 capital instruments are not required to be perpetual. Tier 2 capital consists of the sum of the following elements: (i) instruments issued by the bank that meet the criteria for eligibility and stock surplus resulting from the issuance of those instruments, (ii) instruments issued by certain consolidated subsidiaries of the bank, (iii) certain loan loss provisions (those reserves held against future, presently unidentified losses that are freely available to meet losses which subsequently materialize, limited to a maximum of 1.25 percent of credit risk-weighted risk assets) and (iv) certain regulatory adjustments.

Compliance can be costly, but new standards are necessary in order to provide for a more stable financial system.

Quantitative Requirements

Common Equity Tier 1 must be at least 4.5 percent of risk-weighted assets at all times. Total Tier 1 capital must be at least 6 percent of risk-weighted assets at all times. Total capital (Tier 1 plus Tier 2) must be at least 8 percent of risk-weighted assets at all times.

Mandatory Disclosure

As proposed in December 2009, a bank will have to provide a full reconciliation of all regulatory capital elements back to the balance sheet in their audited financial statements, list separately all regulatory adjustments and items not deducted from Common Equity Tier1, and describe the main features of all capital instruments it issues. In addition, banks' websites must provide the full terms and conditions of all instruments included in regulatory capital.

Transitional Arrangements

At the same time that these rules were issued, the Basel Committee issued the results of a quantitative impact study using the December 2009 proposals.[3] Compliance costs would have exceeded U.S. $750 billion if those rules had been considered fully implemented at the end of 2009.[4] Perhaps as a result, the Basel Committee has provided for a lengthy transitional phase. As of Jan. 1, 2013, member countries must have adopted these standards as laws or regulations. As of that date, banks will need to meet a 3.5 percent Common Equity Tier 1 ratio to risk-weighted assets (from the current 2 percent but not yet the 4.5 percent when fully implemented), 4.5 percent Tier 1 capital ratio to risk-weighted assets (from the current 4 percent but not the 6 percent when fully implemented). Full implementation of these Tier 1 ratios must be reached by Jan. 1, 2015. The total capital requirement remains 8 percent of risk-weighted assets.

Leverage Ratio

As noted in December 2009, the Basel Committee wanted to address what it felt was one of the underlying features of the underlying crisis—excess leverage. The Basel Committee characterizes the leverage ratio as a simple, transparent and credible supplementary measure to the risk-based capital requirements. The basis of calculation will be the average of the monthly leverage ratio over the quarter based on certain definitions of capital and total exposure. A minimum Tier 1 leverage ratio of 3 percent will be required between Jan. 1, 2013, and Jan. 1, 2017.

In calculating the capital portion of the ratio, banks will use the new definition of Tier 1 capital described above. During the 2012-2017 transition period, the committee will collect data to track the impact of using total regulatory capital and Common Equity Tier 1 capital as the capital measure. Regulators were to begin monitoring the leverage ratio requirement as of Jan. 1, 2011, on a semi-annual basis and assess whether the 3 percent minimum is appropriate or whether the definition should be revised to encompass more exposures. After the 2013-2017 transition period of monitoring the leverage ratio calculations, any adjustments will be made and a final requirement implemented on Jan. 1, 2018.

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In the United States, well-capitalized banks currently must meet a 5 percent leverage capital ratio and adequately capitalized banks (the minimum requirement) must meet a 4 percent leverage ratio and only if the bank otherwise has a composite 1 examination rating (the highest possible), may it comply with its capital requirements with a 3 percent leverage.[5] While that calculation may change due to the new definitions of capital, U.S. banks and bank holding companies are at least used to the concept. Around the world, other banks may not have as much experience.

Liquidity

In addition to strengthening the capital requirements, the Basel Committee also is instituting new liquidity requirements to act as "shock absorbers" to strengthen a bank's ability to handle stresses in the financial system. Capital is the foundation of a bank's financial strength. Sufficient liquidity on a day-to-day basis is what keeps the bank functioning.

The Basel Committee previously had issued a set of general principles for banks to follow in implementing effective liquidity risk management.[6] Buttressing those principles, the Basel Committee is implementing the two minimum standards proposed in December 2009 for funding liquidity: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

The LCR requirement is aimed at a bank's short-term resilience to stress on its systems by requiring that a bank maintains an "adequate" level of unencumbered high quality liquid assets that can be easily converted to cash to meet its liquidity needs for 30 calendar days during a period of "severe liquidity stress" as may be determined by banking regulators. On a continuous basis, banks will need to maintain sufficient liquid assets to meet at least 100 percent of its estimated net cash outflows on a rolling 30-day basis. In order to avoid the ratio going below 100 percent, banks will need to build in a cushion of over-estimation of outflows against which it will need to maintain assets.

Eligible liquid assets need to be "high quality" and "unencumbered." The fundamental characteristics of a high-quality liquid asset are substantially the same as those proposed in December 2009, such as low credit and market risk, ease and certainty of valuation, low correlation with risky assets, and a sizable active sale or repurchase market. "Unencumbered" means not pledged (whether explicitly or implicitly) to secure, collateralize, or credit-enhance any transaction. However, a bank can use in its calculation (i) unused assets pledged to a central bank or a public sector entity and (ii) assets received in reverse repurchase agreements and secured financing transactions that are held at the bank, have not been rehypothecated, and are legally and contractually available for the bank's use.

The rules provide for two levels of assets but both require that the asset in question be proven to be a reliable source of liquidity. Level 1 assets are substantially similar to those described in the December 2009 proposal: cash, central bank reserves, certain marketable Basel standard zero risk weight securities and certain sovereign debt securities. After a study of other assets that could potentially be used to satisfy the liquid asset requirement, the Basel Committee has put forward a set of assets called Level 2 assets, which can be used for up to 40 percent of the overall liquid asset portfolio, after a minimum 15 percent haircut is made to each asset. Level 2 assets include certain marketable securities assigned a 20 percent risk weight under Basel capital standards and "plain vanilla" corporate bonds with a ready valuation.

As to cash outflows, again the list is substantially similar to what was proposed in December 2009, such as runoff of certain deposits and secured and unsecured fundings. Cash outflow is netted against cash inflow; however, the total amount of cash inflow can only offset up to 75 percent of the cash outflow even if the amount of cash inflow is greater. As a result, a bank always will have to have a portfolio of liquid assets equal to 25 percent of the anticipated outflows. The LCR should be reported at least monthly, with the ability to increase it to more frequent reporting, even daily reporting, at the direction of the particular banking authority.

The NSFR is used with respect to a longer time period, one year instead of the 30 days for the LCR. The objective is to move banks to limit short-term funding sources and change their liquidity risk profiles to seek out more stable longer-term funding of assets and business activities. The NSFR is the ratio of available stable funding to required stable funding. As with the LCR, the ratio must be a minimum of 100 percent.

Similar to what was proposed in December 2009, the amount of available stable funding is the sum of a bank's capital, preferred stock with a maturity of at least one year, and, with a minimum of a 15 percent haircut, a portion of certain deposits. In addition, banks may include wholesale funding with maturities of less than one year that is expected to stay with the institution in the event of a stress event, subject to a 15 percent haircut.

The definition of required stable funding is the same as proposed in December 2009: the sum of the value of the assets held and funded by the institution multiplied by a specific required stable funding (RSF) factor assigned to each particular asset type, added to the amount of off-balance sheet (OBS) activity or potential liquidity exposure multiplied by a specific RSF. The objective of the RSF factor is to approximate the amount of a particular asset that could not be monetized (i.e., converted to cash) through sale or use as collateral in a secured borrowing on an extended basis during a liquidity event lasting one year. As with LCR assets, the assets must be unencumbered.

RSF factors for on-balance sheet assets range from 0 percent for cash up to 85 percent for certain unencumbered loans, and 100 percent for any assets not otherwise covered in another category. Encumbered assets on the balance sheet with maturities of at least a year receive an RSF of 100 percent. For OBS assets, certain credit and liquidity facilities are subject to a 5 percent RSF factor, and determination of RSF factors for all other assets is left up to each banking supervisor. The NSFR should be calculated and reported at least monthly.

Conclusion

Will these new rules really work? The Basel Committee and home country regulators will be reviewing the new calculations closely to determine whether they will be sufficient to improve the resiliency of the banking sector, result in banks being less reliant on excess leverage and ensure banks' adequate liquidity on a continuing basis as well as at times of heightened liquidity stress. A tall order, indeed.

During the transition phase, banks should closely monitor their ability to comply with these requirements and invest in the necessary systems and resources that will enable them to comply. Compliance can be costly, but new standards are necessary in order to provide for a more stable financial system.

1. See "Paying Attention to Proposed Capital and Liquidity Requirements," New York Law Journal, March 10, 2010.
2. See "Basel III: A global regulatory framework for more resilient banks and banking systems," December 2010, and "Basel III: International framework for liquidity risk measurement, standards and monitoring," December 2010. These documents may be accessed at http://www.bis.org.
3. "Results of the comprehensive quantitative impact study," December 2009.
4. "Banks' Tab for Basel III Changes Pegged at $770B," American Banker, Dec. 17, 2010.
5. See, for example, 12 C.F.R. §208.43 (capital measure categories for state-chartered member banks of the Federal Reserve System).
6. "Principles for Sound Liquidity Risk Management and Supervision," September 2008.