

Basel III Handbook

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Abbreviations

ASF	Available Stable Funding
BCBS	Basel Committee on Banking Supervision
CIU	Collective Investment Undertaking
CCP	Central Counterparty
CCR	Counterparty Credit Risk
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CRD	Capital Requirements Directive
CVA	Credit Valuation Adjustment
EBA	European Banking Authority
EPE	Expected Positive Exposure
FSB	Financial Stability Board
FY	Financial Year
G-SIBs	Global Systemically Important Banks
IMM	Internal Model Method
LCR	Liquidity Coverage Ratio
MDA	Maximum Distributable Amount
NSFR	Net Stable Funding Ratio
OTC	Over-the-Counter
PD	Probability of Default
PSE	Public Sector Entity
RSF	Required Stable Funding
RW	Risk-Weight
SIBs	Systemically Important Banks
SIFIs	Systemically Important Financial Institutions
SM	Standardized Method
SME	Small and Medium-Size Entity
SSPE	Securitization Special Purpose Entity
VaR	Value-at-Risk

1

Introduction



16:00

1:00

Recent financial crises have demonstrated numerous weaknesses in the global regulatory framework and in banks' risk management practices. In response, regulatory authorities have considered various measures to increase the stability of the financial markets and prevent future negative impact on the economy. One major focus is on strengthening global capital and liquidity rules.

Basel III addresses this, with the goal of improving the banking sector's ability to absorb shocks arising from financial and economic stress. In December 2010 the Basel Committee on Banking Supervision (BCBS) published the Basel III documents "*Basel III: A global regulatory framework for more resilient banks and banking systems*" (a revised version was published in June 2011) and "*Basel III: International framework for liquidity risk measurement, standards and monitoring*."

With this reform package, the BCBS aims to improve risk management and governance as well as strengthen banks' transparency and disclosure. Basel III is also designed to strengthen the resolution of systemically significant cross-border banks. It covers primarily the following aspects¹:

Definition of capital

Introduction of a new definition of capital to increase the quality, consistency and transparency of the capital base. As the recent crisis demonstrated that credit losses and write-downs come out of retained earnings, which is part of banks' tangible common equity base, under Basel III common equity (i.e., common shares and retained earnings) must be the predominant form of Tier 1 capital. Further, the reform package removes the existing inconsistency in the definition of capital by harmonizing deductions of capital and by increasing transparency through disclosure requirements.

Enhanced risk coverage/ Counterparty Credit Risk

The reforms to the Basel II framework by the BCBS in 2009 and the amendments made in the European Capital Requirements Directive III (CRD III)² increased capital requirements for the trading book and complex securitization positions and introduced stressed value-at-risk capital requirements and higher capital requirements for re-securitizations for both in the banking and trading book. Basel III now adds the following reforms: calculation of the capital requirements for counterparty credit risk (CCR) based on stressed inputs; introduction of a capital charge for potential mark-to-market losses (i.e., credit valuation risk); strengthening standards for collateral management and initial margining; higher capital requirements for OTC derivatives exposures; raising CCR management standards.

Leverage ratio

Introduction of a leverage ratio as a supplementary measure to the risk-based framework of Basel II. The objective is to constrain the build-up of leverage and avoid destabilizing deleveraging processes.

Reducing procyclicality and promoting countercyclical buffers

Introduction of measures to make banks more resilient to procyclical dynamics and avoid the destabilizing effects experienced in the last crisis. The main objectives of these measures are: dampen any excess cyclicality of the minimum capital requirement; promote more forward-looking provisions; conserve capital to build buffers at individual banks and in the banking sector that can be used in periods of stress testing; achieve the broader macro-prudential goal of protecting the banking sector from periods of excess credit growth.

Global liquidity standard

A new liquidity standard is introduced to achieve two objectives. The first objective, pursued by the Liquidity Coverage Ratio (LCR), is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high quality liquid assets to survive a stress scenario lasting one month. The second objective is to promote resilience over the longer term by creating additional incentives for a bank to fund its activities with more stable sources of funding. The Net Stable Funding Ratio (NSFR), with a time horizon of one year, should provide a sustainable maturity structure of assets and liabilities. Basel III also introduces a common set of monitoring tools. The new requirements complement the "Principles for Sound Liquidity Risk Management and Supervision"³ which are included in the CRD II.⁴ The CRD II requirements, implemented into national law by the EU Member States, became effective December 31, 2010.

This handbook provides a detailed overview of the major changes of Basel III corresponding to the EU rules. It focuses on aspects related to banks. Amendments regarding supervisory authorities in the context of enhanced supervision are not covered in detail. The status of topics currently under discussion is included here, as are differences between the EU rules and the Basel III documents from the BCBS.

The enhancements of the capital framework within "Basel 2.5" (CRD II and CRD III in the EU), which are already in force or become applicable beginning in 2012 are not within the scope of this manual. Nor are the challenges banks face with the implementation of the Basel III requirements.⁵

Figure 1: From Basel 2.5 to Basel III

	"Basel 2.5"	"Basel III"		
Legal basis (EU)	<ul style="list-style-type: none"> • CRD (2009/111/EC) published in the Official Journal (Nov. 2009) (CRD II) 	<ul style="list-style-type: none"> • CRD (2010/76/EU) published in the Official Journal (Dec. 2010) (CRD III) 	<ul style="list-style-type: none"> • "CRD IV" (package of two legal instruments: directive and regulation) 	
Status European/national implementation	<ul style="list-style-type: none"> • Transposed into national law 	<ul style="list-style-type: none"> • Partially transposed into national law 	<ul style="list-style-type: none"> • "Basel III" published by the BCBS in Dec. 2010 (rev. version of capital framework June 2011) • Directive and Regulation published by the European Commission in July 2011; discussed by Parliament and Council in autumn 2011/beginning of 2012 • Directive: to be translated into national law till Dec. 31, 2012; Regulation: no national translation required 	
Coming into force	<ul style="list-style-type: none"> • Dec. 31, 2010 	<ul style="list-style-type: none"> • Dec. 31, 2011 	<ul style="list-style-type: none"> • Jan. 1, 2013 (with transition periods till 2019) 	
Topics	<ul style="list-style-type: none"> • Large exposures • Securitization • Hybrid capital instruments • Liquidity risk management • Cross border supervision 	<ul style="list-style-type: none"> • Re-securitization • Disclosure securitization risks • Trading book • Remuneration policies 	<ul style="list-style-type: none"> • Definition of capital • Liquidity risk • Counterparty credit risk • Leverage ratio • Single rule book (through Regulation) 	<ul style="list-style-type: none"> • Capital buffers • Enhanced governance • Sanctions • Enhanced supervision

Source: Accenture

Basel II and the reform packages of "Basel 2.5" are implemented through directives in the EU (CRD, CRD II, CRD III). That is, the rules need to be transposed into national law with several options and discretions at the national level. Basel III is introduced through two different legal instruments.⁶ Most of the key topics, such as the new definition of capital and the new liquidity ratios, are implemented through a Regulation (a directly applicable legal act, with no further national implementation needed). The objective is to create a level playing field (single rule book). Other aspects, including capital buffers and enhanced governance,

are implemented through a Directive. Following the European legislative process, the next step is for the legal documents published by the European Commission (the proposed Regulations and Directives) to be discussed within the European Parliament and Council.

Despite the single rule book, Member States will retain some flexibility in specific areas which are summarized in Table 1:

Table 1: Flexibility of Member States within the single rule book

Type of Measure

Compatible with Single Rule Book?

EU Macro-prudential Measures

Pillar 1

Does not preclude the measure being specifically targeted to certain regional exposures

Power for the Commission to tighten the requirements temporarily across the board for specific activities and exposures. Special urgency procedure is possible for swift response to macro-prudential developments.

Measure is embedded in the Single Rule Book. It uniformly applies to all institutions across Europe that have the type of exposure concerned.

National Measures

Capital requirements for real estate lending

Special procedure in the Regulation under which Member States can both raise capital requirements and tighten loan-to-value limits for loans secured by commercial and/or residential property.

Measure is embedded in the Single Rule Book. The requirements set by country A apply also to institutions in country B that do business in A.

Countercyclical buffer

Member States can set an additional buffer requirement to dampen excess lending growth more generally. This is to protect the economy/banking sector from any other structural variables and from the exposure of the banking sector to risk factors related to financial stability.

Measure is embedded in the Single Rule Book. The requirements set by country A apply also to institutions in country B that do business in A. This "reciprocity" is mandatory only up to 2.5%.

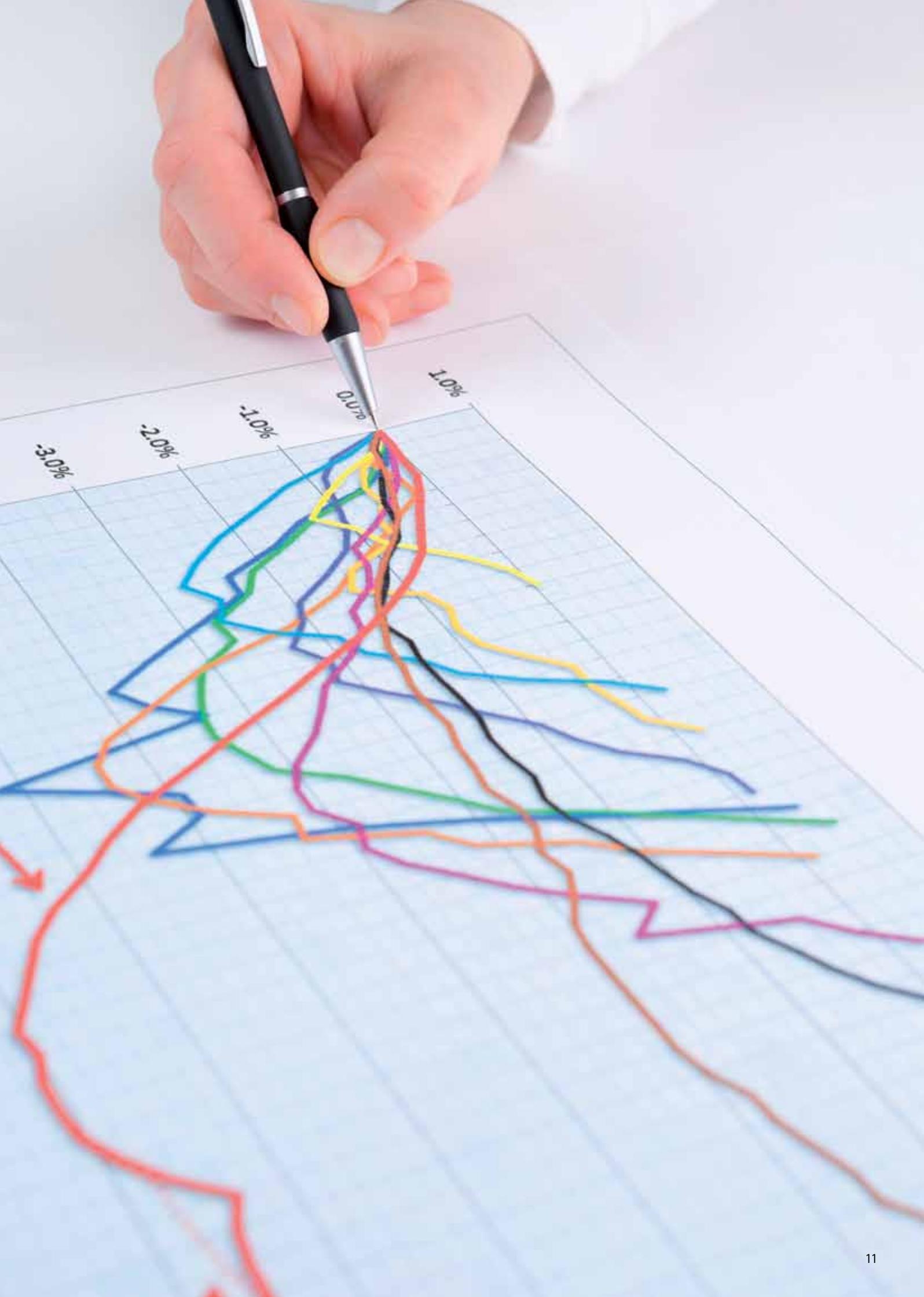
Pillar 2

"Pillar 2" measures

National supervisors can impose a wide range of measures, including additional capital requirements, on individual institutions or groups of institutions to address higher-than-normal risk.

Measures are included in the Directive. They must be justified in terms of particular risks of a given institution or group of institutions, including risks pertaining to a particular region or sector. Further convergence of such measures will be sought over time.

Source: CRD IV – Frequently Asked questions (July 2011), European Commission found at EUROPA – Press Releases – CRD IV – Frequently Asked Questions



2

Definition of capital and capital buffers

2.1 New definition of capital

The financial crisis showed that not all institutions did hold sufficient capital and that the capital was sometimes of poor quality and not available to absorb losses as they materialized. Basel III introduces – based on the amendments made under the CRD II with regard to hybrid capital instruments – a new definition of capital to increase the quality, consistency and transparency of the capital base. It also requires higher capital ratios. Key elements of the revision include⁷:

- Raise quality and quantity of Tier 1 capital;
- Simplification and reduction of Tier 2 capital;
- Elimination of Tier 3 capital;
- More stringent criteria for each instrument;
- Harmonization of regulatory adjustments;
- Enhanced disclosure requirements;
- Introduction of a new limit system for the capital elements.

According to the new definition, capital comprises the following elements:

- Going-concern capital (Tier 1 capital);
 - Common Equity Tier 1 capital (CET 1 capital): Common equity (i.e., common shares and retained earnings) must be the predominant form of Tier 1 capital
 - Additional Tier 1 capital
- Gone-concern capital (Tier 2 capital).

While going-concern capital (Tier 1) should allow an institution to continue its activities and help prevent insolvency, gone-concern capital (Tier 2) would help ensure that depositors and senior creditors can be repaid if the institution fails.

The own funds requirements under Basel III are the following (as a percentage of risk-weighted assets, RWA):

- CET 1 capital ratio of 4.5%;
- Tier 1 capital ratio of 6%;
- Total capital ratio of 8%.

Total capital ratio will remain 8% of RWA. CET 1 capital ratio increases from 2% to 4.5%. Additional Tier 1 capital ratio is 1.5%, leading to a Tier 1 capital ratio of 6%. The importance of Tier 2 capital decreases by reducing the ratio to 2% of RWA.

Apart from these changes, Basel III will introduce two new capital buffers: a capital conservation buffer of 2.5% and a countercyclical buffer of 0–2.5% depending on macroeconomic circumstances (see section 2.6 for a detailed description of the buffers). For both buffers, an extra cushion of CET 1 capital needs to be held leading to a CET 1 capital ratio of up to 9.5%.

Additional capital surcharges between 1% and 2.5% (extra cushion of CET 1 capital) for systemically important financial institutions (SIFIs) – depending on the systemic importance of the institution – are currently in discussion.

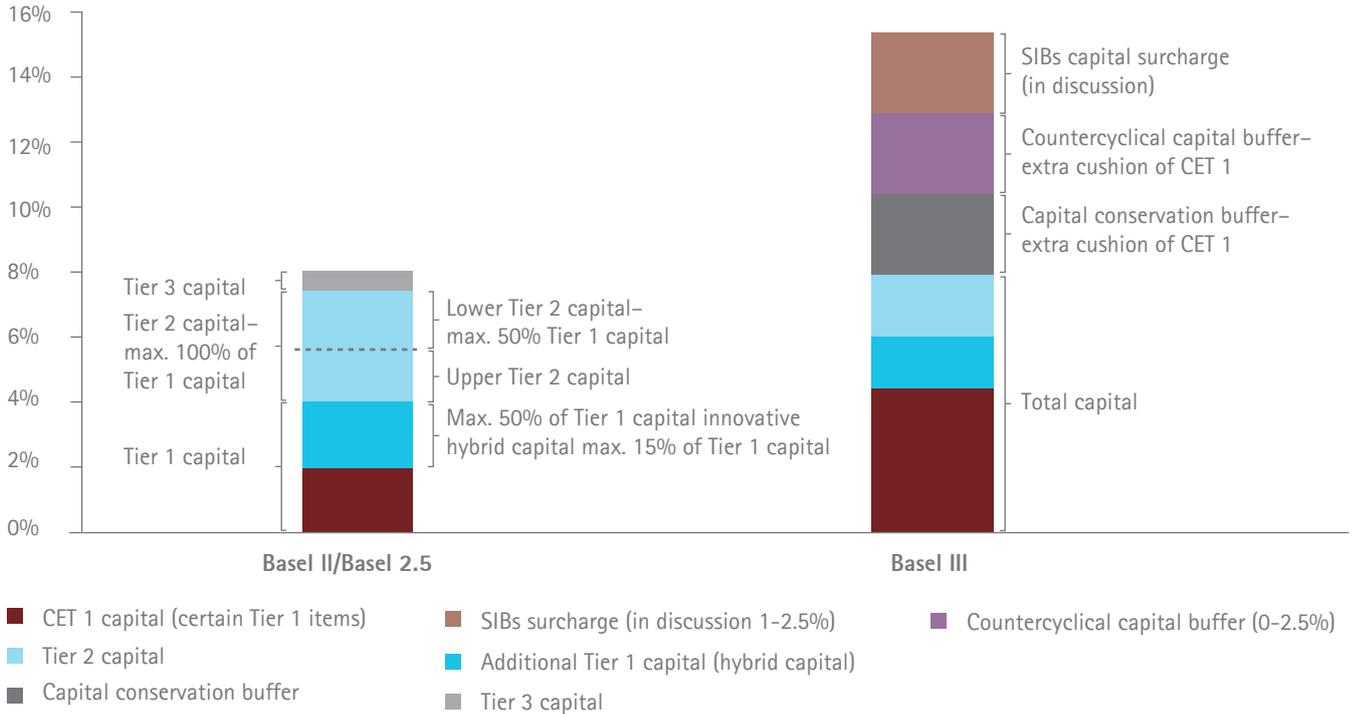
On top of these own funds requirements, supervisory authorities may require extra capital to cover other risks following Pillar 2 (as it is also under the current framework).

Basel III foresees a transition period before the new capital requirements apply in full. The going concern (Tier 1) capital requirements will be implemented gradually between 2013 and 2015; the capital buffers between 2016 and 2019. The new prudential adjustments will be introduced gradually, 20% a year from 2014, reaching 100% in 2018. Grandfathering provisions over 10 years would also apply to capital

instruments that are currently used but do not meet the new rules. They are phased out over a 10-year period beginning in 2013 (10% a year). While the proposals of the BCBS require that these instruments were issued prior to the date of agreement of the new rules by Basel (September 12, 2010), instruments issued after this cut off date would need to comply with the new rules or would not be recognized as capital as of January 1, 2013. The proposals of the EU Regulation set the cut off date "as the date of adoption of the proposal by the Commission, when the Commission as a College agreed to legally implement Basel III in the EU. Setting a cut off date prior to this policy decision would neither be legitimate nor legally sound, as it would apply the new rules retroactively."⁸

The latest proposals from the BCBS follow a principles-based approach in regard to capital, with the focus on the substance of the capital instruments. They also ensure that the new rules are capable of being applied to the highest-quality capital items of non-joint stock companies, such as cooperative banks. Through a set of principles, the EU standard specifies in greater detail the application of the new definition of capital to instruments issued by non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Like the BCBS proposals, it imposes 14 strict criteria that instruments need to meet.

Figure 2: Capital requirements Basel II/Basel 2.5 vs. Basel III



Source: Accenture, based on Basel III – Leitfaden zu den neuen Eigenkapital- und Liquiditätsregeln für Banken (2011), Bundesbank and CRD IV – Frequently Asked Questions (2011), European Commission.

Note: The treatment of hybrid capital instruments was amended within the CRD II (harmonization of the eligibility criteria and limits of hybrid capital instruments); further amendments follow within Basel III.

Figure 3: Phase-in arrangements Basel III capital requirements



Source: New proposals on capital requirements (July 2011), European Commission.

2.2 Components of capital

2.2.1 Common Equity Tier 1 capital

A key aspect of the stricter definition of capital is that Common Equity Tier 1 (CET 1) instruments – mainly common shares (or comparable instruments) and retained earnings – must be the predominant form of Tier 1 capital. According to the proposed EU Regulation, CET 1 items consist of the following:⁹

- a) Capital instruments, provided the conditions laid down in Article 26 of the proposed EU Regulation are met;
- b) Share premium accounts related to the instruments referred to in point a;
- c) Retained earnings;
- d) Accumulated other comprehensive income;
- e) Other reserves;
- f) Funds for general banking risk.

CET 1 items of mutuals, cooperative societies or similar institutions include capital instruments by an institution under its statutory terms provided the following conditions are met:

- a) The institution is of a type that is defined under applicable national law and which competent authorities consider to qualify as a mutual, cooperative society or a similar institution;
- b) The conditions laid down in Articles 26 and 27 of the proposed EU Regulation are met;
- c) The instrument does not possess features that could cause the condition of the institution to be weakened as a going concern during periods of market stress.

The European Banking Authority (EBA) has the mandate to develop draft regulatory technical standards to specify the points previously mentioned. These include features that could cause the condition of an institution to be weakened as a going concern during periods of market stress.

According to Article 26 of the proposed EU Regulation, capital instruments need to meet all of the following conditions to qualify as CET 1 items:¹⁰

- a) The instruments are issued directly by the institution with the prior approval of the owners of the institution or, where permitted under applicable national law, the management body of the institution;
- b) The instruments are paid up and their purchase is not funded directly or indirectly by the institution;
- c) The instruments meet all the following conditions as regards their classification:
 - i) They qualify as capital within the meaning of Article 22 of Directive 86/635/EEC;
 - ii) They are classified as equity within the meaning of the applicable accounting standard;
 - iii) They are classified as equity capital for the purposes of determining balance sheet insolvency, where applicable under national insolvency law;
- d) The instruments are clearly and separately disclosed on the balance sheet in the financial statements of the institution;
- e) The instruments are perpetual;
- f) The principal amount of the instruments may not be reduced or repaid, except in either of the following cases:
 - i) The liquidation of the institution;
 - ii) Discretionary repurchases of the instruments or other discretionary means of reducing capital, where the institution has received the prior consent of the competent authority in accordance with Article 72 of the proposed EU Regulation;
 - g) The provisions governing the instruments do not indicate expressly or implicitly that the principal amount of the instruments would or might be reduced or repaid other than in the liquidation of the institution, and the institution does not otherwise provide such an indication prior to or at issuance of the instruments, except in the case of instruments referred to in Article 25 of the proposed EU Regulation, where the refusal by the institution to redeem such instruments is prohibited under applicable national law;
 - h) The instruments meet the following conditions as regards distributions:
 - i) There are no preferential distributions, including in relation to other Common Equity Tier 1 instruments, and the terms governing the instruments do not provide preferential rights to payment of distributions;
 - ii) Distributions to holders of the instruments may be paid only out of distributable items;
 - iii) The conditions governing the instruments do not include a cap or other restriction on the maximum level of distributions, except in the case of the instruments referred to in Article 25 of the proposed EU Regulation;

iv) The level of distributions is not determined on the basis of the amount for which the instruments were purchased at issuance, and is not otherwise determined on this basis, except in the case of the instruments referred to in Article 25 of the proposed EU Regulation;

v) The conditions governing the instruments do not include any obligation for the institution to make distributions to their holders and the institution is not otherwise subject to such an obligation;

vi) Non-payment of distributions does not constitute an event of default of the institution;

i) Compared to all the capital instruments issued by the institution, the instruments absorb the first and proportionately greatest share of losses as they occur, and each instrument absorbs losses to the same degree as all other Common Equity Tier 1 instruments;

j) The instruments rank below all other claims in the event of insolvency or liquidation of the institution;

k) The instruments entitle their owners to a claim on the residual assets of the institution, which, in the event of its liquidation and after the payment of all senior claims, is proportionate to the amount of such instruments issued and is not fixed or subject to a cap, except in the case of the capital instruments referred to in Article 25 of the proposed EU Regulation;

l) The instruments are not secured, or guaranteed by any of the following:

i) The institution or its subsidiaries;

ii) The parent institution or its subsidiaries;

iii) The parent financial holding company or its subsidiaries;

iv) The mixed activity holding company or its subsidiaries;

v) The mixed financial holding company and its subsidiaries;

vi) Any undertaking that has close links with the entities referred to in points (i) to (v);

m) The instruments are not subject to any arrangement, contractual or otherwise, that enhances the seniority of claims under the instruments in insolvency or liquidation.

Capital instruments issued by mutuals, cooperative societies and similar institutions need to meet the conditions mentioned in Article 26 of the proposed EU Regulation (see above) as well as the following conditions as with respect to the redemption of the capital instruments to qualify as CET 1 instruments:

a) Except where prohibited under applicable national law, the institution shall be able to refuse the redemption of the instruments;

b) Where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption;

c) Refusal to redeem the instruments, or the limitation of the redemption of the instruments where applicable, may not constitute an event of default of the institution.

The EU also addresses the topic of "silent partnership," pointing out that it is a generic term covering capital instruments with widely varying characteristics (e.g., in terms of ability to absorb losses). Whether or not silent partnership would qualify as a CET 1 item depends on the characteristics of the instrument. The items must be of extremely high quality and able to absorb losses fully as they occur.¹¹

The CET 1 capital should include CET 1 items after the application of regulatory adjustments, deductions and exemptions and alternatives.

2.2.2 Additional Tier 1 capital

Additional Tier 1 instruments include: a) instruments where the below-mentioned conditions of Article 49 of the proposed EU Regulation are met; and b) the share premium accounts related to these instruments.

According to Article 49 of the proposed EU Regulation, capital instruments need to meet all of the following conditions to qualify as additional Tier 1 capital items:

- a) The instruments are issued and paid up;
- b) The instruments are not purchased by any of the following:
 - i) The institution or its subsidiaries;
 - ii) An undertaking in which the institution has participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital of that undertaking;
 - c) The purchase of the instruments is not funded directly or indirectly by the institution;
- d) The instruments rank below Tier 2 instruments in the event of the insolvency of the institution;
- e) The instruments are not secured, or guaranteed by any of the following:
 - i) The institution or its subsidiaries;
 - ii) The parent institution or its subsidiaries;
 - iii) The parent financial holding company or its subsidiaries;
 - iv) The mixed activity holding company or its subsidiaries;
 - v) The mixed financial holding company and its subsidiaries;
 - vi) Any undertaking that has close links with entities referred to in points (i) to (v);
- f) The instruments are not subject to any arrangement, contractual or otherwise, that enhances the seniority of the claim under the instruments in insolvency or liquidation;

g) The instruments are perpetual and the provisions governing them include no incentive for the institution to redeem them;

h) Where the provisions governing the instruments include one or more call options, the option to call may be exercised at the sole discretion of the issuer;

i) The instruments may be called, redeemed or repurchased only where the conditions laid down in Article 72 of the proposed EU Regulation are met, and not before five years after the date of issuance;

j) The provisions governing the instruments do not indicate explicitly or implicitly that the instruments would or might be called, redeemed or repurchased and the institution does not otherwise provide such an indication;

k) The institution does not indicate explicitly or implicitly that the competent authority would consent to a request to call, redeem or repurchase the instruments;

l) Distributions under the instruments meet the following conditions:

- i) They are paid out of distributable items;
- ii) The level of distributions made on the instruments will not be modified based on the credit standing of the institution, its parent institution or parent financial holding company or mixed activity holding company;
- iii) The provisions governing the instruments give the institution full discretion at all times to cancel the distributions on the instruments for an unlimited period and on a non-cumulative basis, and the institution may use such cancelled payments without restriction to meet its obligations as they fall due;
- iv) Cancellation of distributions does not constitute an event of default of the institution;
- v) The cancellation of distributions imposes no restrictions on the institution;

m) The instruments do not contribute to a determination that the liabilities of an institution exceed its assets, where such a determination constitutes a test of insolvency under applicable national law;

n) The provisions governing the instruments require the principal amount of the instruments to be written down, or the instruments to be converted to CET 1 instruments, upon the occurrence of a trigger event;

o) The provisions governing the instruments include no feature that could hinder the recapitalization of the institution;

p) Where the instruments are not issued directly by the institution or by an operating entity within the consolidation pursuant to prudent consolidation (Chapter 2 of Title II of Part One), the parent institution, the parent financial holding company, or the mixed activity holding company, the proceeds are immediately available without limitation in a form that satisfies the conditions laid down in this paragraph to any of the following:

- i) The institution;
- ii) An operating entity within the consolidation pursuant to Chapter 2 of Title II of Part One;
- iii) The parent institution;
- iv) The parent financial holding company;
- v) The mixed activity holding company.

The EU standard¹² requires that all capital instruments recognized in the Additional Tier 1 capital are written down or converted into Common Equity Tier 1 instruments when the CET 1 capital ratio falls below 5.125% (contingent capital). Contingent capital not fulfilling these requirements will not be recognized as regulatory capital.

Regarding hybrid capital instruments, the EU standard builds upon the amendments made under the CRD II concerning the quality of such instruments, introducing stricter eligibility criteria for inclusion in Additional Tier 1 capital. Hybrid capital instruments need to absorb losses by being written down or converted into CET 1 instruments when CET 1 capital ratio falls below 5.125%. Hybrid capital instruments with an incentive to redeem, which are currently limited to 15% of the Tier 1 capital base (see CRD II), will be phased out under Basel III.

The Additional Tier 1 capital base consists of the corresponding instruments after deductions.

2.2.3 Tier 2 capital

The new definition of capital rationalizes Tier 2 capital by eliminating Upper Tier 2 from the capital structure. It also introduces harmonized and strict eligibility criteria. Under Basel III, Tier 2 capital ensures loss absorption in case of liquidation (gone-concern).

Tier 2 capital includes the following items:

- a) Capital instruments, where the conditions laid down in Article 60 are met;
- b) The share premium accounts related to the instruments referred to in point (a);
- c) For institutions calculating risk-weighted exposure amounts in accordance with the Standardized Approach, general credit risk adjustments, gross-of-tax effects, of up to 1.25% of risk-weighted exposure amounts calculated in accordance with the Standardized Approach;
- d) For institutions calculating risk-weighted exposure amounts under the Internal Ratings Based approach (IRB), positive amounts, gross-of-tax effects, resulting from the calculation laid down in Article 154 and 155 up to 0.6% of risk-weighted exposure amounts calculated under the IRB approach.

According to Article 60 of the proposed EU Regulation, instruments need to fulfill the following conditions to qualify as Tier 2 capital:

- a) The instruments are issued and fully paid-up;
- b) The instruments are not purchased by any of the following:
 - i) The institution or its subsidiaries;
 - ii) An undertaking in which the institution has participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital of that undertaking;
- c) The purchase of the instruments is not funded directly or indirectly by the institution;
- d) The claim on the principal amount of the instruments under the provisions governing the instruments is wholly subordinated to claims of all non-subordinated creditors;
- e) The instruments are not secured, or guaranteed by any of the following:
 - i) The institution or its subsidiaries;
 - ii) The parent institution or its subsidiaries;
 - iii) The parent financial holding company or its subsidiaries;
 - iv) The mixed activity holding company or its subsidiaries;
 - v) The mixed financial holding company and its subsidiaries;
 - vi) Any undertaking that has close links with entities referred to in points (i) to (v);
- f) The instruments are not subject to any arrangement that otherwise enhances the seniority of the claim under the instruments;
- g) The instruments have an original maturity of at least five years;
- h) The provisions governing the instruments do not include any incentive for them to be redeemed by the institution;
- i) Where the instruments include one or more call options, the options are exercisable at the sole discretion of the issuer;

j) The instruments may be called, redeemed or repurchased only where the conditions laid down in Article 72 of the proposed EU Regulation are met, and not before five years after the date of issuance;

k) The provisions governing the instruments do not indicate or suggest that the instruments would or might be redeemed or repurchased other than at maturity and the institution does not otherwise provide such an indication or suggestion;

l) The provisions governing the instruments do not give the holder the right to accelerate the future scheduled payment of interest or principal, other than in the insolvency or liquidation of the institution;

m) The level of interest or dividend payments due on the instruments will not be modified based on the credit standing of the institution, its parent institution or parent financial holding company or mixed activity holding company;

n) Where the instruments are not issued directly by the institution or by an operating entity within the consolidation pursuant to prudent consolidation (Chapter 2 of Title II of Part One), the parent institution, the parent financial holding company, or the mixed activity holding company, the proceeds are immediately available without limitation in a form that satisfies the conditions laid down in this paragraph to any of the following:

- i) The institution;
- ii) An operating entity within the consolidation pursuant to Chapter 2 of Title II of Part One;
- iii) The parent institution;
- iv) The parent financial holding company;
- v) The mixed activity holding company.

The Tier 2 capital base consists of the corresponding instruments after deductions.

2.3 Prudential filters and deductions

2.3.1 Prudential filters

The Basel III standard harmonizes regulatory adjustments (i.e., deductions from capital and prudential filters) which will generally be applied at the level of CET 1 capital or its equivalent in the case of non-joint stock companies in the future.

Table 2: Prudential filters Basel III

Regulatory Adjustments

Item	Description
Prudential filters	
Securitized assets	An institution shall exclude from any element of own funds any increase in its equity under the applicable accounting standard that results from securitized assets.
Cash flow hedges and changes in the value of own liabilities	The fair value reserves related to gains or losses on cash flow hedges of financial instruments that are not valued at fair value, including projected cash flows; and gains or losses on liabilities of the institution that are valued at fair value that result from changes in the credit standing of the institution should not be included in any element of own funds.
Additional value adjustments	Institutions shall apply the requirements for prudent valuation specified in the proposed Regulation to all their assets measured at fair value when calculating the amount of their own funds and shall deduct from CET 1 capital the amount of any additional value adjustments necessary.
Unrealized gains and losses measured at fair value	Institutions shall generally not make adjustments to remove from their own funds unrealized gains or losses on their assets or liabilities measured at fair value.

Source: New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

2.3.2 Deductions from CET 1 capital

Table 3: Deduction from CET 1 capital in Basel III

Regulatory Adjustments

Item	Description
Deductions from CET 1 capital	
Losses for current fiscal year	
Intangible assets	Institutions shall determine the intangible assets to be deducted in accordance with the following: (a) the amount to be deducted shall be reduced by the amount of associated deferred tax liabilities that would be extinguished if the intangible assets became impaired or were derecognized under the relevant accounting standard; (b) the amount to be deducted shall include goodwill included in the valuation of significant investments of the institution.
Deferred tax assets	Deferred tax assets that rely on future profitability according to Article 35 of the proposed EU Regulation. Deferred tax assets that do not rely on future profitability according to Article 36 of the proposed EU Regulation.
Negative expected losses	IRB banks should deduct negative amounts resulting from the calculation of expected loss (see Article 37 of the EU proposed Regulation).
Benefit pension fund assets	Benefit pension fund assets should be deducted according to Article 38 of the proposed EU Regulation.
Direct and indirect holding of CET 1 items	Direct and indirect holdings by an institution of own CET1 instruments, including own CET 1 instruments that an institution is under an actual or contingent obligation to purchase by virtue of an existing contractual obligation (see Article 39 of the proposed EU Regulation).
Holdings of CET 1 items of entities with reciprocal cross holding	Holdings of the CET 1 instruments of relevant entities where those entities have a reciprocal cross holding with the institution that the competent authority considers to have been designed to inflate artificially the own funds of the institution (see Article 41 of the proposed EU Regulation).
Not-significant investments in relevant entities	The applicable amount of direct and indirect holdings by the institution of CET 1 instruments of relevant entities where the institution does not have a significant investment in those entities (see Article 43 of the proposed EU Regulation).
Significant investments in relevant entities	The applicable amount of direct and indirect holdings by the institution of the CET 1 instruments of relevant entities where the institution has a significant investment (e.g., the institution owns more than 10% of the CET 1 instruments issued by that entity) in those entities (see Article 40 of the proposed EU Regulation).
Amount that exceed Additional Tier 1 capital	The amount of items required to be deducted from Additional Tier 1 items that exceed the Additional Tier 1 capital of the institution.
Alternative to risk-weight of 1.250%	The exposure amount of the specified items (e.g., qualifying holdings outside the financial sector) which qualify for a risk-weight of 1.250%, where the institution deducts that exposure amount from CET 1 capital as an alternative to applying a risk-weight of 1.250%.
Tax charge	Any tax charge relating to CET 1 items foreseeable at the moment of its calculation, except where the institution suitably adjusts the amount of CET 1 items insofar as such tax charges reduce the amount up to which those items may be applied to cover risks or losses.

Source: New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

2.3.3 Exemptions from and alternatives to deduction from CET 1 items

The following items, which in aggregate are equal to or less than 15% of the CET 1 capital of the institution (after adjustments), may not be deducted from CET 1 capital:

- Deferred tax assets that are dependent on future profitability and arise from temporary differences, and in aggregate are equal to or less than 10% of the CET 1 items of the institution (after adjustments);
- Significant investments in a relevant entity,¹³ the direct and indirect holdings of that institution of the CET 1 instruments of those entities that in aggregate are equal to or less than 10% of the CET 1 items of the institution (after adjustments).

Instruments that are not deducted shall be assigned a risk-weight of 250%.

The EU standard allows alternatives to the deduction of significant holdings of institutions in the CET 1 instruments of other financial entities like insurance undertakings, reinsurance undertakings and insurance holding companies included in the scope of consolidated supervision (Article 46 of the proposed EU Regulation). The European Commission justifies this aspect with the so-called "bancassurance" business model which is a key feature of the EU banking landscape, i.e., groups that contain significant banking/investment businesses and insurance businesses.¹⁴

Further, the standard permits mutuals, cooperative societies or similar institutions not to deduct significant and not-significant holdings in another such institution or in its central or regional credit institution if the specified conditions are met (see chapter 2.5).

2.3.4 Deductions from Additional Tier 1 capital

Table 4: Deduction from Additional Tier 1 capital in Basel III

Regulatory Adjustments

Item	Description
Deductions from Additional Tier 1 capital	
Direct and indirect holding of Additional Tier 1 items	Direct and indirect holdings by an institution of own Additional Tier 1 instruments, including own Additional Tier 1 instruments that an institution could be obliged to purchase as a result of existing contractual obligations (see Article 54 of the proposed EU Regulation).
Holdings of Additional Tier 1 items of entities with reciprocal cross holding	Holdings of the Additional Tier 1 instruments of relevant entities with which the institution has reciprocal cross holdings that the competent authority considers to have been designed to inflate artificially the own funds of the institution (see Article 55 of the proposed EU Regulation).
Not-significant investments in relevant entities	Direct and indirect holdings of the Additional Tier 1 instruments of relevant entities, where an institution does not have a significant investment in those entities (see Article 57 of the proposed EU Regulation).
Significant investments in relevant entities	Direct and indirect holdings by the institution of the Additional Tier 1 instruments of relevant entities where the institution has a significant investment in those entities, excluding underwriting positions held for five working days or fewer.
Amount that exceeds Tier 2 capital	The amount of items required to be deducted from Tier 2 items that exceed the Tier 2 capital of the institution.
Tax charge	Any tax charge relating to Additional Tier 1 items foreseeable at the moment of its calculation, except where the institution suitably adjusts the amount of Additional Tier 1 items insofar as such tax charges reduce the amount up to which those items may be applied to cover risks or losses.

Source: New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm



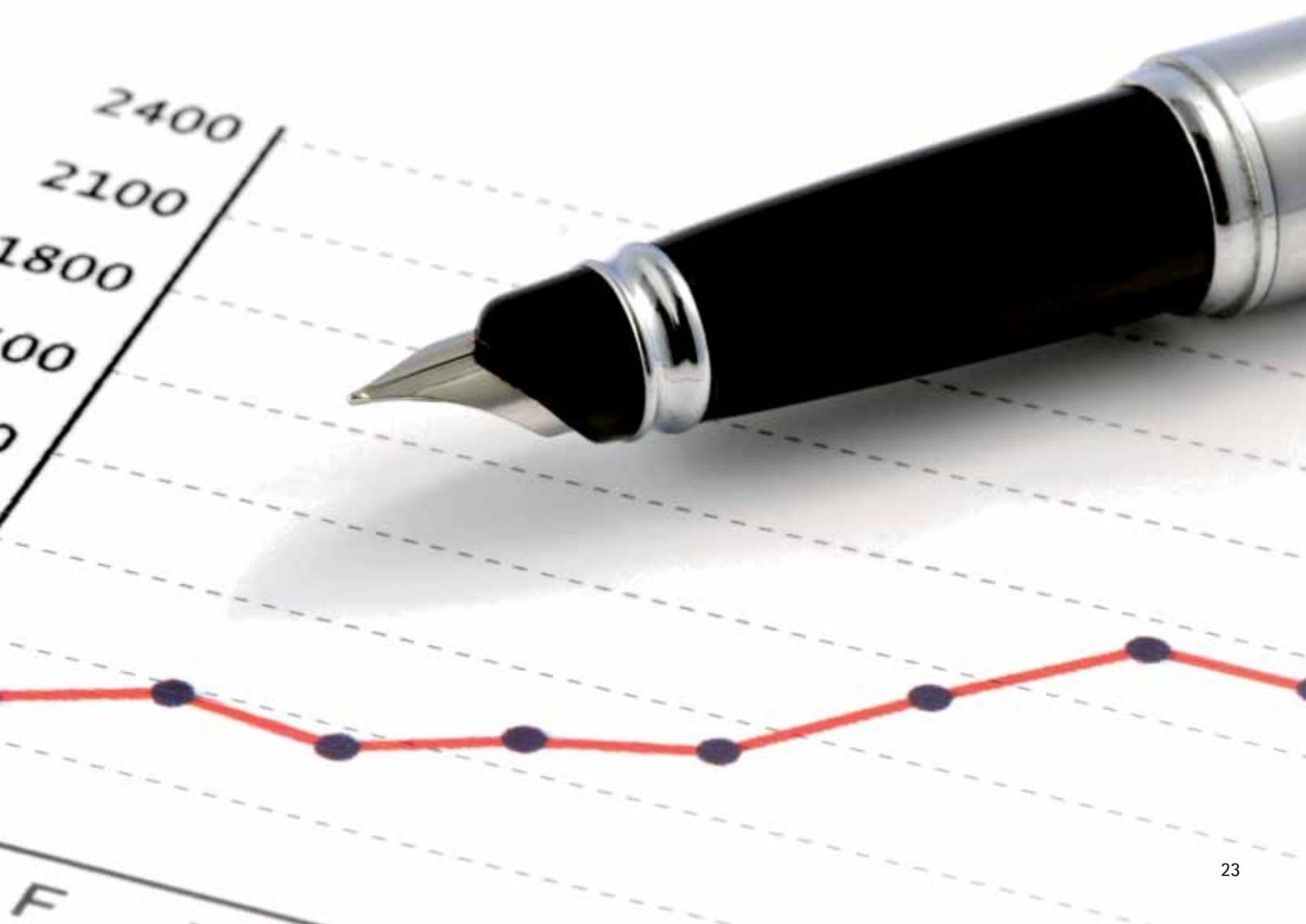
2.3.5 Deductions from Tier 2 items

Table 5: Deduction from Additional Tier 2 capital in Basel III

Regulatory Adjustments

Item	Description
Deductions from Tier 2 capital	
Direct and indirect holding of Tier 2 items	Direct and indirect holdings by an institution of own Tier 2 instruments, including own Tier 2 instruments that an institution could be obliged to purchase as a result of existing contractual obligations.
Holdings of Additional Tier 2 items of entities with reciprocal cross holding	Holdings of the Tier 2 instruments of relevant entities with which the institution has reciprocal cross holdings that the competent authority considers to have been designed to inflate artificially the own funds of the institution (see Article 65 of the proposed EU Regulation).
Not-significant investments in relevant entities	The applicable amount determined in accordance with Article 67 of direct and indirect holdings of the Tier 2 instruments of relevant entities, where an institution does not have a significant investment in those entities.
Significant investments in relevant entities	Direct and indirect holdings by the institution of the Tier 2 instruments of relevant entities where the institution has a significant investment in those entities, excluding underwriting positions held for fewer than 5 working days.

Source: New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm



2.4 Minority interests

2.4.1 Minority interests that qualify for inclusion in consolidated CET 1 capital

Minority interest includes CET 1 instruments, the related retained earnings and share premium accounts of a subsidiary where the following conditions are met:

- a) The subsidiary is one of the following:
 - i) An institution;
 - ii) An undertaking that is subject by virtue of applicable national law to the requirements of the proposed EU Regulation and proposed Directive;
- b) The subsidiary is included fully in the consolidation;
- c) Those CET 1 instruments are owned by persons other than the undertakings included in the consolidation.

Minority interests that are funded directly or indirectly, through a special-purpose entity or otherwise, by the parent institution, parent financial holding company, mixed activity holding company or their subsidiaries shall not qualify as consolidated CET 1 capital.

Institutions should determine the amount of minority interests of a subsidiary included in the consolidated CET 1 capital according to Article 79 of the proposed EU Regulation.

2.4.2 Qualifying Additional Tier 1, Tier 1, Tier 2 capital and qualifying own funds

Qualifying Additional Tier 1, Tier 1, Tier 2 capital and qualifying own funds include the minority interest, Additional Tier 1, Tier 1 or Tier 2 instruments, as applicable, plus the related retained earnings and share premium accounts, of a subsidiary where the following conditions are met:

- a) The subsidiary is one of the following:
 - i) An institution;
 - ii) An undertaking that is subject by virtue of applicable national law to the requirements of the proposed EU Regulation and proposed Directive;
- b) The subsidiary is included fully in the consolidation;
- d) Those instruments are owned by persons other than the undertakings included in the consolidation.

Additional Tier 1 and Tier 2 capital issued by special-purpose entities may be included only if the conditions specified in Article 78 of the proposed EU Regulation are met.

Institutions should determine the amount of qualifying Tier 1 capital of a subsidiary that is included in the consolidated Tier 1 capital and consolidated Additional Tier 1 capital according to Articles 80–81 of the proposed EU Regulation. The amount of qualifying own funds of a subsidiary that is included in consolidated own funds and in consolidated Tier 2 capital shall be determined according to Article 82 and 83 respectively of the proposed EU Regulation.

2.5 Institutional networks

The EU standard allows mutuals, cooperative societies or similar institutions not to deduct significant and not-significant holdings in another such institution or in its central or regional credit institution if the following conditions are met:

- i) Where the holding is in a central or regional credit institution, the institution with that holding is associated with that central or regional credit institution in a network subject to legal or statutory provisions and the central or regional credit institution is responsible, under those provisions, for cash-clearing operations within that network;
- ii) The institutions fall within the same institutional protection scheme;
- iii) The competent authorities have granted the permission referred to in Article 108(7);¹⁵
- iv) The conditions laid down in Article 108(7) are satisfied;
- v) The institution draws up and reports to the competent authorities the consolidated balance sheet referred to in point (e) of Article 108(7) no less frequently than own funds requirements are required to be reported under Article 95.

A regional credit institution may not deduct holdings in its central or another regional credit institution if the conditions mentioned above are met.

2.6 Capital buffers

Basel III introduces two capital buffers in addition to the capital requirements: a capital conservation buffer and a countercyclical capital buffer. While the definition of capital is treated in the proposed EU Regulation, the capital buffers are discussed in the corresponding proposed Directive requiring national transposition.¹⁶

2.6.1 Capital conservation buffer

The capital conservation buffer, 2.5% of RWA and to be met with CET 1 capital, applies at all times and it is intended to ensure that institutions are able to absorb losses in stress periods lasting for a number of years. Considering the 4.5% CET 1 capital ratio, institutions must hold 7.0% CET 1 capital on an individual and consolidated basis at all times. Institutions are expected to build up the capital in good economic times.

In case institutions fail to meet fully the "combined buffer requirement" (i.e., the total CET 1 capital required to meet the requirement for the capital conservation buffer extended by an institution-specific countercyclical capital buffer), distribution constraints on CET 1 capital are imposed. CET 1 capital should thereby include the following items:

- a) A payment of cash dividends;
- b) A distribution of fully or partly paid bonus shares or other capital instruments;
- c) A redemption or purchase by an institution of its own shares or other specified capital instruments;
- d) A repayment of amounts paid up in connection with specified capital instruments;
- e) A distribution of items referred to in points (b) to (e) of Article 24(1) of that Regulation.

Falling below the combined buffer requirement, institutions have to calculate the "Maximum Distributable Amount" (MDA). The factor to

calculate the MDA depends on how much an institution is dropping below the requirement and ranges from 0% (first/lowest quartile) to 60% (fourth/highest quartile).¹⁷

Further, the affected institutions should prepare a capital conservation plan and submit it to the competent authorities including the following: estimates of income and expenditure and a forecast balance sheet; measures to increase the capital ratios of the institution; and a plan and timeframe for the increase of own funds with the objective of meeting fully the combined buffer requirement.

The capital conservation buffer partly solves the regulatory paradox after which higher minimum capital should not be used to absorb losses falling below the minimum requirements, leading to a withdrawal of the banking license. With the introduced capital buffers and the associated distribution constraints falling below the requirements, a "softer" regulatory tool is introduced.¹⁸

2.6.2 Countercyclical capital buffer

The countercyclical capital buffer is introduced to "achieve the broader macro-prudential goal of protecting the banking sector and the real economy from the system-wide risks stemming from the boom-bust evolution in aggregate credit growth and more generally from any other structural variables and from the exposure of the banking sector to any other risk factors related to risks to financial stability."¹⁹ The level of this buffer is set by each Member State, ranges between 0% and 2.5% of RWA²⁰ and has to be met by CET 1 capital.²¹ The buffer is required during periods of excessive credit growth and it is released in an economic downturn.

In cases where institutions fail to meet fully the countercyclical capital buffer requirements, capital distribution constraints are imposed (see above).

The designated authority that is responsible for setting the buffer should calculate a buffer guide based on a deviation of the ratio of credit-to-GDP from its long-term trend on a quarterly basis. An increase of the countercyclical capital buffer should generally be communicated 12 months in advance. A decrease of the buffer could be applicable immediately. The designated authority should give an indicative (not binding) period during which no increase in the buffer is expected.

International institutions need to calculate the institution-specific countercyclical capital buffer which consists of the weighted average of the countercyclical buffer rates that apply in the jurisdictions where the relevant credit exposures of the institution are located (based on the own funds requirements for credit risk).

2.7 Enhanced disclosure requirements

The proposed EU Regulation includes improved disclosure requirements regarding the capital endowment and own funds of institutions. The purpose is to strengthen market discipline and enhance financial stability. The corresponding technical standards to specify uniform formats, frequencies, etc., are to be developed by the European Banking Authority and submitted to the European Commission by January 1, 2013.

3

Counterparty Credit Risk



350

371

390

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Basel III strengthens the requirements for the management and capitalization of counterparty credit risk (CCR). It includes an additional capital charge for possible losses associated with deterioration in the creditworthiness of counterparties or increased risk-weights on exposures to large financial institutions. The new framework also enhances incentives for clearing over-the-counter (OTC) instruments through central counterparties (CCP).²²

3.1 Effective Expected Positive Exposure

For banks using an Internal Model Method (IMM) to calculate CCR regulatory capital, Basel III requires determining the default risk capital charge by using the greater of the portfolio-level capital charge (not including CVA charge) based on Effective Expected Positive Exposure (EEPE) using current market data and the one based on EEPE using a stress calibration. The greater of the EEPEs should not be applied on a counterparty-by-counterparty basis, but on a total portfolio level.

3.2 Credit valuation adjustment

In addition to the default risk capital requirements for CCR, Basel III introduces an additional capital charge to cover the risk of mark-to-market losses on the expected counterparty risk (Credit Valuation Adjustment, CVA) to OTC derivatives. The calculation of the CVA charge depends on the method banks use to determine the capital charge for CCR and specific-interest rate risk. Transactions with a central counterparty (CCP) and securities financing transactions (SFT) need not be considered.

Banks with IMM approval for CCR risk and approval to use the market risk internal models approach for the specific-interest rate risk of bonds must calculate the additional capital charge by modeling the impact of changes in the counterparty's credit spread on the CVAs of all OTC derivatives using the internal VaR model for bonds. This VaR model is restricted to changes in the counterparties' credit spreads and does not model the sensitivity of CVA to changes in other market factors such as changes in the value of the reference asset, commodity, currency or interest rate of a derivative. The CVA risk capital charge consists of both general and specific credit spread risks, including Stressed VaR but excluding incremental risk charge (IRC).

All other banks must calculate a standardized CVA risk capital charge. Within this method – it is based on the bond equivalent approach – portfolio own funds requirements for CVA risk for each counterparty have to be calculated using the given formula.

The calculation of the aggregate CCR and CVA risk capital charges depends on the methods used by banks.

- For banks with IMM approval and market-risk internal-models approval for the specific interest-rate risk of bonds, the total CCR capital charge is the sum of the following components:

- i) The higher of (a) its IMM capital charge based on current parameter calibrations for EAD and (b) its IMM capital charge based on stressed parameter calibrations for EAD;

- ii) The advanced CVA risk capital charge calculated with the internal models.

- For banks with IMM approval and without Specific-Risk VaR approval for bonds, the total CCR capital charge is the sum of the following components:

- i) The higher of (a) its IMM capital charge based on current parameter calibrations for EAD and (b) its IMM capital charge based on stressed parameter calibrations for EAD;

- ii) The standardized CVA risk capital charge.

- For all other banks, the total CCR capital charge is the sum of the following components:

- i) The sum over all counterparties of the Current Exposure Method (CEM) or Standardized Method (SM)-based capital charge (depending on the bank's CCR approach);

- ii) The standardized CVA risk capital charge.

3.3 Wrong way risk

In addition to the consideration of general wrong way risk – stress testing and scenario analysis must be designed to identify such risks – Basel III introduces an explicit Pillar 1 capital charge for specific wrong way risk. Banks are exposed to specific wrong way risk if future exposure to a specific counterparty is highly, positively correlated with the counterparty's probability of default. Banks must "have procedures in place to identify, monitor and control cases of specific wrong way risk, beginning at the inception of a trade and continuing through the life of the trade. To calculate the CCR capital charge, the instruments for which there exists a legal connection between the counterparty and the underlying issuer, and for which specific wrong way risk has been identified, are not considered to be in the same netting set as other transactions with the counterparty. Furthermore, for single-name credit default swaps where a legal connection exists between the counterparty and the underlying issuer, and where specific wrong way risk has been identified, EAD counterparty exposure equals the full expected loss in the remaining fair value of the underlying instruments assuming the underlying issuer is in liquidation."²³

3.4 Asset value correlation

Basel III increases the risk-weights (RW) on exposures to financial institutions relative to the non-financial corporate sector in the IRB approach. The correlation coefficient in the IRB formula is increased by 25% for all exposures to large regulated financial entities and to all unregulated financial entities.²⁴ In effect, a multiplier of 1.25 is introduced. The proposals of the EU

Regulation consider institutions as "large" if the total assets, on the level of that individual firm or on the consolidated level of the group, are greater than or equal to EUR 70 billion threshold. The Basel III document by the BCBS includes a threshold of US \$100 billion.

Depending on the probability of default of the institution, the introduction of this multiplier increases the risk-weight by approximately 20% to 35%. A detailed calculation is provided in the appendix of this handbook.

3.5 Central counterparties

The new capital framework also enhances incentives for clearing instruments through central counterparties (CCP) by applying lower own funds requirements relative to OTC transactions. Also, the additional CVA capital charge does not apply to exposures towards eligible CCPs. It should be noted that several conditions need to be fulfilled to classify as CCP.

While so far there is no capital charge for derivatives with a CCP the proposed EU Regulation introduces own funds requirements for trade exposures. According to this an institution has to apply a risk-weight of 2% to the exposure values of all its trade exposures with CCPs. An exposure value of zero can be used in cases where the posted collaterals to a CCP or a clearing member bankruptcy are remote events, or if the CCP, the clearing member or one or more of the other clients of the clearing member becomes insolvent.

In addition to institutions acting as clearing members, they have to hold own funds to cover the exposures arising from their contributions to the default fund of a CCP, the corresponding methodology is specified in Article 298 of the proposed EU Regulation.

3.6 Enhanced CCR management requirements

Basel III strengthens not only the CCR measurement but also the CCR management by requiring institutions to establish and maintain a CCR management framework consisting of:

- a) Policies, processes and systems to ensure the identification, measurement, management, approval and internal reporting of CCR;
- b) Procedures for ensuring that those policies, processes and systems are complied with.

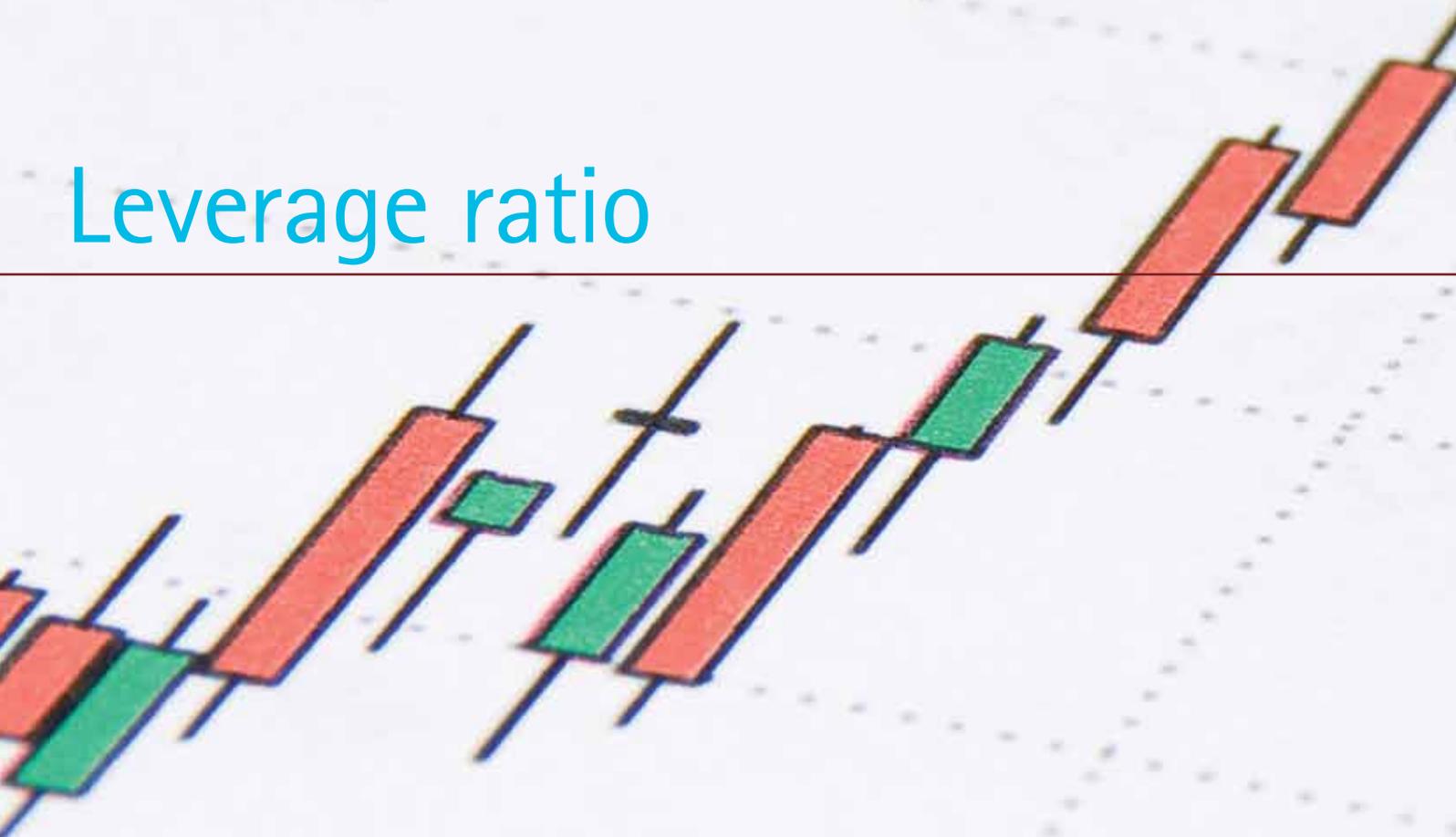
The framework should ensure that institutions comply with the following principles:

- a) It does not undertake business with a counterparty without assessing its creditworthiness;
- b) It takes due account of settlement and pre-settlement credit risk;
- c) It manages such risks as comprehensively and practicable at the counterparty level by aggregating CCR exposures with other credit exposures and at the firm-wide level.

Basel III also includes new requirements for CCR back testing and stress testing. Banks must have a comprehensive stress testing program including regular execution, single- and multi-factor tests, trade coverage and internal control. In addition, new requirements for collateral management and policies are stipulated. The regulatory floor for the margin period of risk will increase, depending on the counterparty portfolio and historic margin call failures.

4

Leverage ratio





4.1 Definition and calibration

To prevent an excessive build-up of leverage on institutions' balance sheets, Basel III introduces a non-risk-based leverage ratio to supplement the risk-based capital framework of Basel II. This new regulatory tool is not intended to be a binding instrument at this stage but as an "additional feature that can be applied on individual banks at the discretion of supervisory authorities with a view to migrating to a binding ('Pillar one') measure in 2018, based on appropriate review and calibration."²⁵ Reporting requirements from January 1, 2013 would allow a corresponding review and decision on its introduction as a binding requirement in 2018. Starting in 2015, publication of the leverage ratio by the institutions is proposed.²⁶

The leverage ratio should be calculated by dividing an institution's capital measure by the total exposure (expressed as a percentage). The ratio should be calculated as the simple

arithmetic mean of the monthly leverage ratios over a quarter.²⁷

For the numerator of the ratio (capital measure), the Tier 1 capital should be considered. The denominator (exposure measure) should be the sum of the exposure values of all assets and off-balance sheet items not deducted from the calculation of Tier 1 capital. For off-balance-sheet items, a specific credit risk adjustment of 10% generally applies for undrawn credit facilities, (this may be cancelled unconditionally at any time without notice), and 100% for all other off-balance-sheet items.²⁸

At this time a leverage ratio of 3% is proposed. By October 31, 2016, the EBA will report to the European Commission among others on whether 3% would be an appropriate level for a Tier 1 capital-based leverage ratio and whether the leverage ratio should be the same for all institutions or differ

for various types of institutions. Based on the EBA report, final adjustments of the ratio would be made in the first half of 2017. The EBA would develop drafts of technical standards to determine the contents and format of the uniform reporting template.

Within the disclosure requirements, the following information should be reported:

- a) The leverage ratio;
- b) A breakdown of the total exposure measure;
- c) A description of the processes used to manage the risk of excessive leverage;
- d) A description of the factors that had an impact on the leverage ratio during the period to which the disclosed leverage ratio refers.

Figure 4: Leverage Ratio within Basel III

$$\text{Leverage Ratio} = \frac{\text{Tier 1 capital}}{\text{Total exposure}} \geq 3\%$$

- Exposure measure generally follows accounting measure
- Credit risk adjustment for off-balance-sheet items:
 - Generally 100%
 - 10% for unconditionally cancellable commitments

Calculation

Simple arithmetic mean of the monthly leverage ratio over the quarter

Scope of application

Solo, consolidated and sub-consolidated level

Disclosure

Disclosure of the key elements of the leverage ratio under Pillar 3

Introduction

Planned for Jan. 1, 2018

Transition period

- Jan. 1, 2011: Start supervisory monitoring period (development of templates)
- Jan. 1, 2013 – Jan. 1, 2017: Parallel run (leverage ratio and its components will be tracked, including its behavior relative to the risk based requirement)
- Jan. 1, 2015: Disclosure of the leverage ratio by banks
- First half of 2017: Final adjustments
- Jan. 1, 2018: Migration to Pillar 1 treatment

Source: Accenture



5

Global liquidity standard

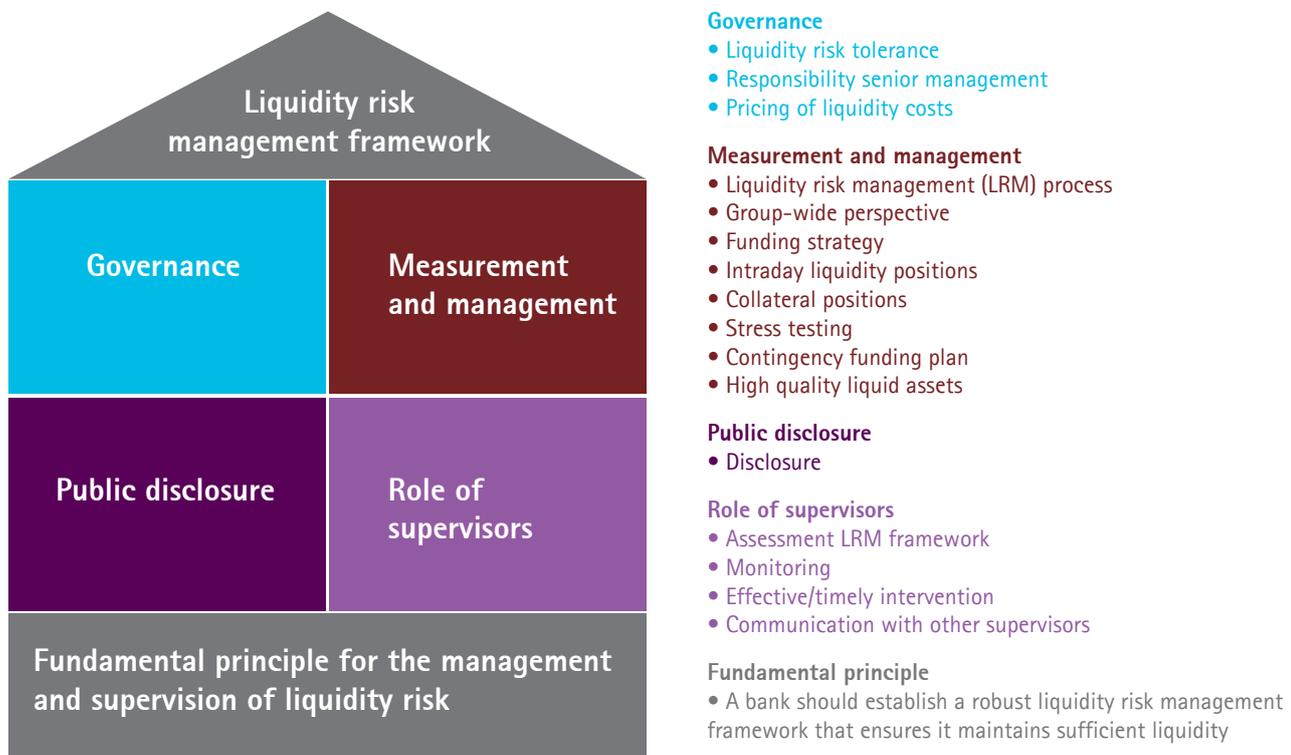


Basel III includes a new liquidity standard introducing two liquidity ratios. The Liquidity Coverage Ratio (LCR) is introduced to improve the short-term resilience of the liquidity risk profile of institutions, requiring them to hold a buffer of "high quality" liquid assets to match net liquidity outflows during a 30-day period of stress. The Net Stable Funding Ratio (NSFR) is designed to promote resilience over the longer term by requiring institutions to fund their activities with more stable sources of funding on an ongoing structural basis.

Further, EBA will develop draft implementation technical standards regarding liquidity monitoring metrics which should allow competent authorities to obtain a comprehensive view of the liquidity risk profiles of institutions. The Basel III document from the BCBS contains a number of monitoring tools which are presented in section 5.3.

It should be noted that institutions are not only expected to meet the new standards but also to adhere to the Principles for Sound Liquidity Risk Management and Supervision.²⁹ These principles provide guidance on the risk management and supervision of liquidity and funding risk and have been considered in the context of the CRD II. The following figure gives an overview of the relevant topics.

Figure 5: Liquidity risk management (LRM) framework



Source: Accenture

5.1 Liquidity Coverage Ratio

The Liquidity Coverage Ratio (LCR) requires institutions to hold a sufficient buffer of "high quality" liquid assets to cover net liquidity outflows during a 30-day period of stress. The stock of high quality liquid assets (numerator) should include assets of high credit and liquidity quality. The stress scenario that is used to determine the net cash outflows (denominator) reflects both institution-specific and systemic shocks.³⁰

The LCR will be introduced by 2015 after an observation period to avoid possible unintended consequences. From 2013 on, there is a general requirement for banks to keep appropriate liquidity coverage.

According to the proposed EU Regulation, the LCR will in principle apply at the level of every individual institution (with legal personality). Competent authorities may – subject

to stringent conditions – waive the application to a consolidated requirement.³¹

To meet the requirement, institutions shall "at all times hold liquid assets, the sum of the values of which equals, or is greater than, the liquidity outflows less the liquidity inflows under stressed conditions so as to ensure that institutions maintain levels of liquidity buffers which are adequate to face any possible imbalance between liquidity inflows and outflows under stressed conditions over a short period of time. Institutions shall not count double liquidity inflows and liquid assets."³²

If an institution does not meet the requirements, it is asked to notify the competent authorities and submit a plan for the timely restoration of compliance with the LCR requirement. Until the institution has restored compliance, it must report the items to

the competent authorities on a daily basis.

The LCR should be reported on a monthly basis. Competent authorities may authorize a lower reporting frequency on the basis of the individual situation of an institution. Competent authorities might also require institutions with significant liquidity risk in a foreign currency to report these items separately.

Figure 6: Liquidity Coverage Ratio (LCR)

$$\text{LCR} = \frac{\text{High quality liquid assets}}{\text{Total net liquidity outflows over 30-day time period}} \geq 100\%$$

Institutions have to ensure that they have at all times sufficient high quality liquid assets to survive an acute stress scenario lasting for 30 days

Introduction

Jan. 1, 2015; observation period starting Jan. 1, 2013

Scope of application

Level of individual institution (with legal personality)

Reporting

Monthly with the operational capacity to increase the frequency to weekly or even daily in stressed situations

Disclosure

Disclosure of LCR under Pillar 3

Source: Accenture

5.1.1. Definition of high-quality liquid assets

The following items should qualify as liquid assets:

- a) Cash and deposits held with central banks to the extent that these deposits can be withdrawn in times of stress;
- b) Transferable assets that are of extremely high liquidity and credit quality;
- c) Transferable assets representing claims on or guaranteed by the central government of a Member State or a third country if the institution incurs a liquidity risk in that Member State or third country that it covers by holding those liquid assets;
- d) Transferable assets that are of high liquidity and credit quality.

As an operational requirement, items listed in points a, b and c (also called "level 1 assets") should not be less than 60% of the liquid assets of an institution. Such items owed and due or callable within 30 calendar days shall not count towards 60% unless the assets have been obtained against collateral that qualifies under points a, b or c.

Regarding the definition of "high" and "extremely high" liquidity and credit quality of transferable assets, EBA will work on a uniform definition until December 31, 2013, considering the following criteria: minimum trade volume of the assets; credit quality steps; average volume traded and average trade size; remaining time to maturity. Until then, institutions themselves should identify the corresponding transferable assets that are of high or extremely high liquidity and credit quality.

Institutions should not consider the following items as high quality liquid assets:

a) assets that are issued by a credit institution unless they fulfill one of the following conditions:

- i) They are bonds eligible for treatment as covered bonds;
 - ii) They are bonds as defined in Article 52(4) of Directive 2009/65/EC³³ other than those referred to in (i);
 - iii) The credit institution has been set up and is sponsored by a Member State central or regional government and the asset is guaranteed by that government and used to fund promotional loans granted on a non-competitive, not-for-profit basis in order to promote its public policy objectives;
- b) Assets issued by any of the following:
- i) An investment firm;
 - ii) An insurance undertaking;
 - iii) A financial holding company;
 - iv) A mixed-activity holding company;
 - v) Any other entity that performs one or more of the activities listed in Annex I of the Directive as its main business (e.g., financial leasing; acceptance of deposits and other mutual recognition).

The items shall fulfill the following conditions to qualify as high quality liquid assets:

- a) They are not issued by the institution itself or its parent or subsidiary institutions or another subsidiary of its parent institutions or parent financial holding company;
- b) They are eligible collateral in normal times for intraday liquidity needs and overnight liquidity facilities of a central bank in a Member State or, if the liquid assets are held to meet liquidity outflows in the currency of a third country, of the central bank of that third country;

c) Their price can be determined by a formula that is easy to calculate based on publicly available inputs and does not depend on strong assumptions as is typically the case for structured or exotic products;

d) They are listed on a recognized exchange;

e) They are tradable on active outright sale or repurchase agreement markets with a large and diverse number of market participants, a high trading volume and market breadth and depth.

Items have to fulfill several operational requirements to be considered as high-quality liquid assets:

- a) They are appropriately diversified;
- b) "Level 1 assets" should not be less than 60% of the liquid assets (see above);
- c) They are legally and practically readily available at any time during the next 30 days to be liquidated via outright sale or repurchase agreements in order to meet obligations coming due;
- d) The liquid assets are controlled by a liquidity management function;
- e) A portion of the liquid assets is periodically and at least annually liquidated via outright sale or repurchase agreements for the following purposes:
 - i) To test the access to the market for these assets,
 - ii) To test the effectiveness of its processes for the liquidation of assets,
 - iii) To test the usability of the assets,
 - iv) To minimize the risk of negative signaling during a period of stress;

f) Price risks associated with the assets may be hedged but the liquid assets are subject to appropriate internal arrangements that ensure that they will not be used in other ongoing operations, including:

- i) Hedging or other trading strategies;
- ii) Providing credit enhancements in structured transactions;
- iii) To cover operational costs;

g) The denomination of the liquid assets is consistent with the distribution by currency of liquidity outflows after the deduction of capped inflows.

The value of the liquid assets shall be the market value, subject to appropriate haircuts. For level 2 assets the haircut shall not be less than 15%. If institutions hedge the price risk, they should take into account the cash flow resulting from the potential close-out of the hedge. Shares or units in CIUs should be subject to haircuts, looking through to the underlying assets. The haircuts range from 0% to 20%.

Figure 7: LCR: High quality liquid assets

$$\text{LCR} = \frac{\text{High quality liquid assets}}{\text{Total net liquidity outflows over 30-day time period}} \geq 100\%$$

High quality liquid assets

Conditions high quality liquid assets (e.g.,)

- Not issued by the institution or parent/subsidiary
- Eligibility as collateral in normal times for intraday liquidity needs and overnight liquidity facilities of a Central Bank
- Listed on a recognized exchange

Operational requirements (e.g.,)

- Appropriate diversification
- Assets are legally and practically readily available at any time during the next 30 days
- Liquid assets are controlled by a liquidity management function

High quality liquid assets items

- "Level 1 assets" (cash; transferable assets of extremely high liquidity and credit quality): min. 60% of liquid assets; market value; no haircut
- "Level 2 assets" (transferable assets that are of high liquidity and credit quality): max. 40% of liquid assets; market value; haircut of min. 15%

Source: Accenture

5.1.2. Definition of net liquidity outflows

The denominator of the LCR consists of the net liquidity outflows over a 30-day period of stress. They are calculated as the liquidity inflows minus the outflows, whereas the inflows are limited to 75% of liquidity outflows.

The liquidity outflows are calculated by multiplying the assets with the specified "run off" factors; the inflows, by multiplying the assets with the specified inflow factor.

5.1.2.1 Liquidity outflows

Liquidity outflows are calculated as the sum of the following items:

a) 5% of retail deposits that are covered by a Deposit Guarantee Scheme and the depositor is either:

i) Part of an established relationship making withdrawal highly unlikely;

ii) held in a transactional account, including accounts to which salaries are regularly credited;

10% of other retail deposits;³⁴

b) For other liabilities that come due, can be called for payout, or entail an implicit expectation of the provider of the funding that the institution would repay the liability during the next 30 days, the following percentages should be used to calculate liquidity outflows:

i) 0% of the liabilities resulting from the institution's own operating expenses;

ii) 0% of liabilities resulting from secured lending and capital-market-driven transactions which are collateralized with high quality liquid assets (up to the value of the liquid assets); 100% of the remaining liabilities;

iii) 25% of liabilities resulting from secured lending and capital-market-driven transactions if the assets would not qualify as liquid assets, the lender is the central bank or another public

sector entity of the Member State in which the credit institution was authorized.

iv) For liabilities resulting from deposits that have to be maintained:

(a) By the depositor in order to obtain clearing, custody or cash management services from the institution;

(b) In the context of common task sharing within an institutional protection scheme or as a legal or statutory minimum deposit by another entity being a member of the same institutional protection scheme;

5% in case of point a) to the extent to which they are covered by a Deposit Guarantee Scheme or an equivalent deposit guarantee scheme in a third country, and by 25% otherwise;

v) 75% of liabilities resulting from deposits by clients that are not financial customers

vi) 100% of payables and receivables expected over the 30-day horizon from the contracts listed in Annex II into account on a net basis across counterparties;

vii) 100% of other liabilities.

c) Collateral other than "level 1" assets which is posted by the institution for contracts listed in Annex II shall be subject to an additional outflow of 15% of the market value of assets for "level 2" assets and 20% of the market value of other assets;

d) Outflows from credit and liquidity facilities that qualify as medium or medium-to-low risk, which shall be determined as a percentage of the maximum amount that can be drawn during the next 30 days. The maximum amount should be multiplied by:

i) 5% if the facilities qualify for the retail exposure class under the standardized or IRB approaches for credit risk;

Figure 8: LCR: Net liquidity outflows

$$\text{LCR} = \frac{\text{High quality liquid assets}}{\text{Total net liquidity outflows over 30-day time period}} \geq 100\%$$

Net liquidity outflows =

Liquidity outflows – Min (Liquidity inflows; 75% of liquidity outflows)

Net liquidity outflows

Liquidity outflows minus liquidity inflows in the stress scenario
The scenario includes firm-specific and systemic factors

Calculation liquidity outflows

Multiplication of the items with the respective "run off" factor

Calculation liquidity inflows

Multiplication of the items with the specified inflow factor;
inflows are capped at 75% of the outflows

Source: Accenture

ii) 10% if they do not qualify for retail exposure; have been provided to clients that are not financial customers; have not been provided for the purpose of replacing funding of the client in situations when the client is unable to obtain funding requirements in the financial markets;

iii) 100% applies in particular to (a) liquidity facilities that the institution has granted to securitization special purpose entity (SSPEs); and (b) arrangements under which the institution is required to buy or swap assets from an SSPE.

e) Additional outflows in period of stress.³⁵

5.1.2.2 Liquidity inflows

Institutions should measure liquidity inflows over the next 30 days. They are limited to 75% of the liquidity outflows and should include only contractual inflows from exposures that are not past due and for which the bank has no reason to expect non-performance within 30 days. Liquidity

inflows should be taken into account in full with the following exceptions:

a) Monies due from customers that are not financial customers shall be reduced by 50% (this does not apply to monies due from secured lending and capital-market-driven transactions that are collateralized by "level 1" and "level 2" assets);

b) Monies due from secured lending and capital-market-driven transactions, if they are collateralized by liquid assets, shall not be taken into account up to the value net of haircuts of the liquid assets but shall be taken into account in full for the remaining monies due;

c) Monies due that the institution owing those monies treats, any undrawn credit or liquidity facilities and any other commitments received shall not be taken into account.

Payables and receivables expected over the 30-day horizon from the contracts listed in Annex II shall be reflected on a net basis across

counterparties and shall be multiplied by 100% of a net amount receivable.

Institutions should not consider inflows from any of the liquid assets (as specified in the proposed Regulation) other than payments due on the assets that are not reflected in the market value of the asset.

Further inflows from new issuance of any obligations should not be taken into account.

Institutions shall take into account liquidity inflows which are to be received in third countries where there are transfer restrictions or which are denominated in non-convertible currencies only to the extent that they correspond to outflows in the third country or currency in question.

Figure 9: LCR: High quality liquid assets and net liquidity outflows

Liquidity Coverage Ratio

$$\text{LCR} = \frac{\text{High quality liquid assets}}{\text{Total net liquidity outflows over 30-day time period}} \geq 100\%$$



High quality liquid assets

- "Level 1" assets
Cash; transferable assets of extremely high liquidity and credit quality (min. 60% of liquid assets)
- "Level 2" assets
Transferable assets that are of high liquidity and credit quality: max. 40% of liquid assets; market value; haircut of min. 15%

Liquidity outflows

- Retail deposits (5-10%)
- Other liabilities coming due during next 30 days (0-100%)
- Collateral other than "level 1" assets (15-20%)
- Credit and liquidity facilities (5-100%)

Liquidity inflows

- Monies due from non financial customer (50%)
- Secured lending and capital market driven transactions (0%-100%)
- Undrawn credit and liquidity facilities (0%)
- Specified payables and receivables expected over the 30 day horizon (100%)
- Liquid assets (0%)
- New issuance of obligations (0%)

≥ 100%

Source: Accenture

5.2 Net Stable Funding Ratio

The Net Stable Funding Ratio (NSFR) requires institutions to maintain a sound funding structure over one year in an extended firm-specific stress scenario. Assets currently funded and any contingent obligations to fund must be matched to a certain extent by sources of stable funding. The minimum requirement described in more detail below is to be introduced by January 1, 2018. There is an observation period until then.

The reporting frequency for the LCR should not be less than monthly. The NSFR should be reported not less than quarterly. Competent authorities are allowed to authorize a lower reporting frequency on the basis of the individual situation of an institution.

The numerator of the NSFR includes the stable sources of funding. The following items shall be reported to competent authorities separately in order to allow an assessment of the availability of stable funding:

- a) Own funds;
- b) The following items not included in the own funds:
 - i) Retail deposits as defined in the Regulation;
 - ii) Deposits that fulfill certain conditions;
 - iii) All funding obtained from financial customers;
 - iv) Funding from secured lending as specified in the Regulation;
 - v) Liabilities resulting from covered bonds;
 - vi) Other liabilities resulting from securities issued;
 - vii) Any other liabilities.

The items shall be presented in the following five time blocks according to maturity date or the earliest date they can be contractually called:

- a) Within 3 months;
- b) Between 3 and 6 months;
- c) Between 6 and 9 months;
- d) Between 9 and 12 months;
- e) After 12 months.

The denominator of the NSFR includes the items requiring stable funding. Institutions shall report the following items to competent authorities in order to allow an assessment of the need for stable funding:

- a) Liquid assets, broken down by asset type;
- b) Securities and money market instruments not included in (a);
- c) Equity securities of non-financial entities listed on a major index in a recognized exchange;
- d) Other equity securities;
- e) Gold;
- f) Other precious metals;
- g) Non-renewable loans and receivables, and separately, those the borrowers of which are:
 - i) Natural persons other than commercial sole proprietor and partnerships and deposits placed by small and medium-size enterprises where the aggregate deposit placed by that client or group of connected clients is less than 1 million EUR;
 - ii) Sovereigns, central banks and PSEs;
 - iii) Clients not referred to in (i) and (ii) other than financial customers;
 - iv) Any other borrowers;
- h) Derivatives receivables;

- i) Any other assets;
- j) Undrawn credit facilities that qualify as 'medium risk' or 'medium/low risk'.

Where applicable, all items shall be reported in the five time blocks described above.

The proposed EU Regulation does not include any "available stable funding factors" (ASF factors) or "required stable funding factors" (RSF factors), i.e., factors by which the available or required stable funding items must be multiplied to calculate the corresponding value. Neither at this time is it stated whether the NSFR should be ">" or "≥" 100%.³⁶

To give an overview of the current discussion regarding ASF and RSF factors, the following figures represent the proposals from the Basel III document of the BCBS.³⁷

Figure 10: Net Stable Funding Ratio

$$\text{NSFR} = \frac{\text{Available stable funding}}{\text{Required stable funding}} \geq 100\%$$

Institutions are required to maintain a sound funding structure over one year in an extended firm-specific stress scenario

Introduction

Jan. 1, 2018; under observation until then

Scope of application

Level of individual institution (with legal personality)

Reporting

Quarterly

Disclosure

Disclosure of NSFR under Pillar 3

Source: Accenture

Figure 11: NSFR: Available stable funding

$$\text{NSFR} = \frac{\text{Available stable funding}}{\text{Required stable funding}} \geq 100\%$$

Available stable funding

Items - ASF factor 100%

- Tier 1 & 2 capital
- Preferred stock not included in Tier 2 capital with maturity ≥ 1 year
- Secured and unsecured borrowings and liabilities with effective remaining maturities ≥ 1 year

Items - ASF factor 90%

- "Stable" non-maturity (demand) deposits and/or term deposits with residual maturity < 1 year

Items - ASF factor 80%

- "Less stable" non-maturity (demand) deposits and/or term deposits with residual maturities < 1 year

Items - ASF factor 50%

- Unsecured wholesale funding, non-maturity deposits and/or term deposits with a residual maturity < 1 year, provided by non-financial corporates, sovereigns, central banks, multilateral development banks and PSEs

Items - ASF factor 0%

- All other liabilities and equity categories not included in the above categories

Source: Accenture

Note: Based on Basel III document from Basel Committee on Banking Supervision

Figure 12: NSFR: Required stable funding

$$\text{NSFR} = \frac{\text{Available stable funding}}{\text{Required stable funding}} \geq 100\%$$

Required stable funding

Items – RSF factor 0%

- Cash
- Unencumbered short-term unsecured instruments and transactions with outstanding maturities < 1 year
- Unencumbered securities with stated remaining maturities < 1 year with no embedded options
- Unencumbered securities held where the institution has an offsetting reverse repurchase transaction
- Unencumbered loans to financial entities with effective remaining maturities < 1 year that are not renewable and for which the lender has an irrevocable right to call

Items – RSF factor 5%

- Unencumbered marketable securities with residual maturities of one year or greater representing claims on or claims guaranteed by sovereigns, central banks, BIS, IMF, EC, non-central government PSEs or multilateral development banks that are assigned a 0% risk-weight under the Basel II standardized approach, provided that active repo or sale-markets exist for these securities

Items – RSF factor 20%

- Unencumbered corporate bonds or covered bonds rated AA- or higher with residual maturities ≥ 1 year satisfying all of the conditions for Level 2 assets in the LCR
- Unencumbered marketable securities with residual maturities ≥ 1 year representing claims on or claims guaranteed by sovereigns, central banks, non-central government PSEs that are assigned a 20% risk-weight under the Basel II standardized approach, provided that they meet all of the conditions for Level 2 assets in the LCR

Items – RSF factor 50%

- Gold
- Unencumbered equity securities, not issued by financial institutions or their affiliates, listed on a recognized exchange and included in a large cap market index
- Unencumbered corporate bonds and covered bonds that are central bank eligible and are not issued by financial institutions

Items – RSF factor 65%

- Unencumbered residential mortgages of any maturity that would qualify for the 35% or lower risk-weight under Basel II Standardized Approach
- Other unencumbered loans, excluding loans to financial institutions, with a remaining maturity of one year or greater, that would qualify for the 35% or lower risk-weight under Basel II Standardized Approach for credit risk

Items – RSF factor 85%

- Unencumbered loans to retail customers and SME (as defined in the LCR) having a remaining maturity < 1 year

Items – RSF factor 100%

- All other assets not included in the above categories

Source: Accenture

Note: Based on Basel III document from Basel Committee on Banking Supervision

5.3 Monitoring tools

A further objective of Basel III is to strengthen and promote global consistency in liquidity risk supervision. According to the proposed EU Regulation, EBA shall develop draft implementing technical standards regarding additional liquidity monitoring metrics that allow competent authorities to obtain a comprehensive view of the liquidity profile of institutions.

In the Basel III document of the BCBS, the following monitoring tools or metrics are proposed.³⁸

Contractual maturity mismatch

Contractual cash and security inflows and outflows from all on- and off-balance sheet items, mapped to defined time bands based on their respective maturities.

Concentration of funding

Different ratios/figures³⁹ to help identify sources of wholesale funding that are of such significance that their withdrawal could trigger liquidity problems.

Available unencumbered assets

Available unencumbered assets that are marketable as collateral in secondary markets and/or eligible for central banks' standing facilities.

LCR by significant currency

Foreign Currency LCR = Stock of high-quality liquid assets in each significant currency / total net cash outflows over a 30-day time period in each significant currency.⁴⁰

Market-related monitoring tools

Early warning indicators based on high-frequency market data with little or no time lag (market wide information; information on the financial sector; bank-specific information).

5.4 Institutional networks

For institutional networks, the Basel III framework includes the following special treatments relating to the calculation of the LCR and NSFR.

a) **LCR:** For calculating liquidity outflows, generally a "run off" factor of 100% should be applied for unsecured wholesale funding. In case of common task sharing within an institutional protection scheme or as a legal or statutory minimum deposit by another entity being a member of the same institutional protection scheme, a factor of 25% can be used by the centralized institution.

For deposits held at the centralized institution in a cooperative banking network that are assumed to stay at the centralized institution, the depositing bank should not count any inflow for these funds. They will receive a 0% inflow rate (by the depositing bank).

b) **NSFR:** As previously mentioned, the proposed EU Regulation does not include any specific ASF and RSF factors. According to the BCBS document for liabilities versus financial institutions there should generally be applied an ASF factor of 0% when calculating the available stable funding. These are not recognized as stable sources of funding. A possible exception to this treatment is for stable deposits from cooperative banks that are required by law to be placed at the central organization and are legally constrained within the cooperative bank network as "minimum deposit requirements." These deposits shall be assigned an ASF factor of 75% or 50% depending on whether the depositor is a retail or SME client or a non-financial corporate client.

6

Enhanced governance and sanctions



6.1 Enhanced governance

Among other deficiencies, the recent financial crisis demonstrated shortcomings in corporate governance arrangements in the financial services industry, contributing to excessive risk-taking. According to the Basel Committee on Banking Supervision and the EU Commission in many cases risk oversight by boards was inadequate, often due to insufficient time commitment, inadequate technical knowledge or insufficient diversity in board composition. Boards were often not sufficiently involved in the overall risk strategy or did not spend sufficient time discussing risk issues, as risk management was considered a low priority compared to other concerns. In addition, the risk management function has not been given appropriate weight in the decision-making process.⁴¹

With the proposed Directive,⁴² the non-binding nature of most of the corporate governance principles which contributed to the lack of compliance with these principles should be transformed into binding regulations. This should help avoid excessive risk taking. The strengthening of the corporate governance framework requires:

- Increasing the effectiveness of risk oversight by boards;
- Improving the status of the risk management function; and
- Ensuring effective monitoring by supervisors of risk governance.

The table on page 49 provides a summarized overview of the options on corporate governance.

6.2 Sanctions

With the proposed Directive, the divergent and not-always-appropriate national sanctioning regimes for key violations of the CRD would be harmonized. At this point, in some Member States the levels of administrative pecuniary sanctions are too low and thus are an insufficient deterrent, or the actual application of sanctions differs in Member States.⁴³

With the new rules, effective, proportionate and deterrent sanctions would be imposed to ensure compliance with the CRD rules. For the European Commission, the most appropriate options to achieve that objective would be a combination of the following:

- Minimum common rules on the type of administrative sanctions available to competent authorities;
- Minimum common rules on maximum level of pecuniary administrative sanctions;
- List of key factors to be taken into account when determining the administrative sanctions;
- Obligation to provide for the application of administrative sanctions to both individuals and credit institutions;
- Publication of sanctions as a general rule.

Table 6: Options on corporate governance

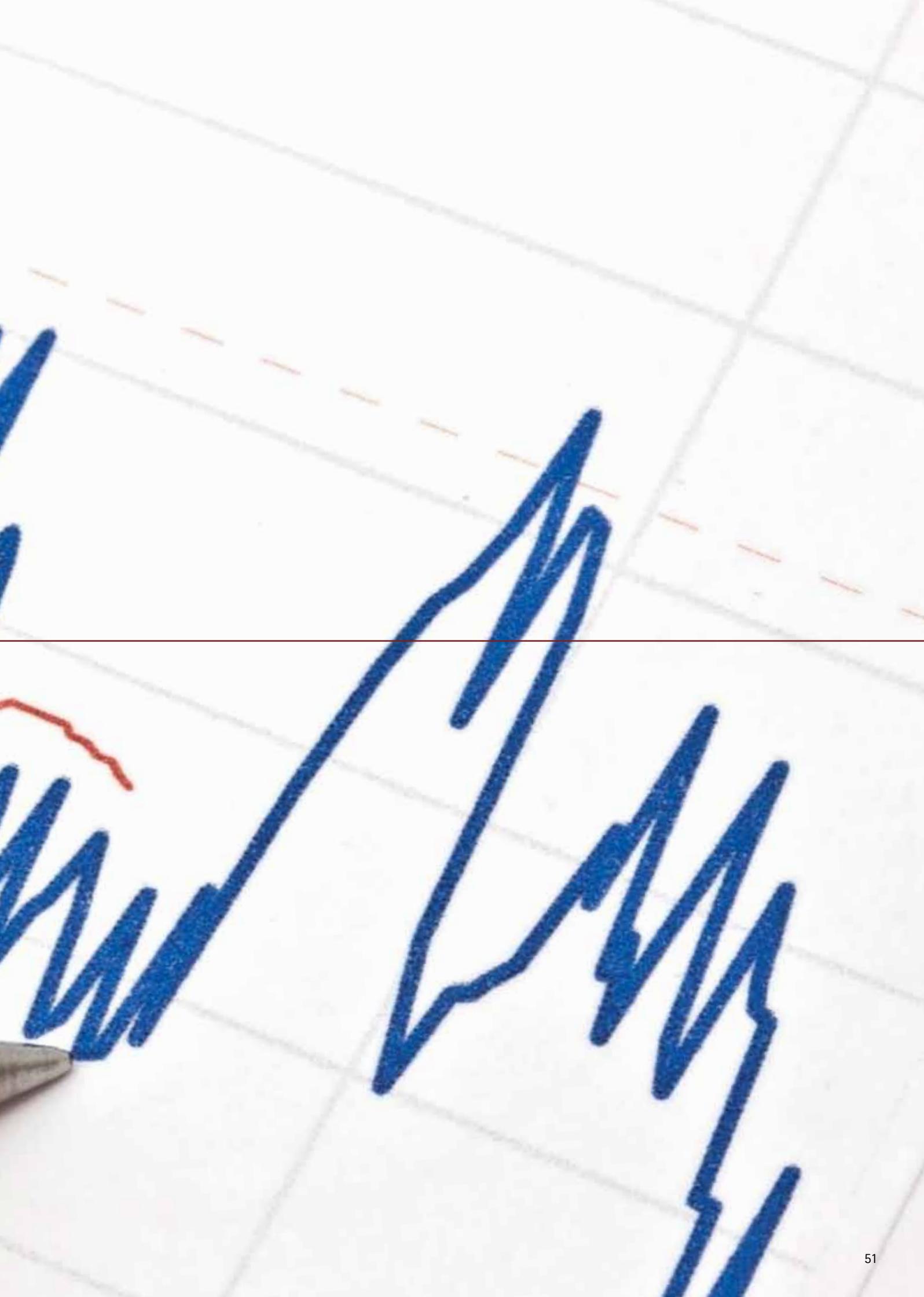
Improve time commitment of board members	<ul style="list-style-type: none">• Require credit institutions to disclose the number of mandates of board members• Require board members to spend sufficient time exercising their duties• Limit the maximum number of mandates a board member may hold at the same time
Improve expertise of board members	<ul style="list-style-type: none">• Require disclosure of the recruitment policy and the actual expertise and skills of board members• Specify skills and expertise that board members must possess individually and collectively• Require that board members receive appropriate induction and continuous training• Mandatory nomination committee
Counterbalance management dominance	<ul style="list-style-type: none">• Prohibit cumulating mandates of chairman and chief executive officer in the same credit institution
Improve diversity in boards' composition	<ul style="list-style-type: none">• Require disclosure of internal policy on diversity• Benchmarking different practices at national and European level• Require diversity as one of the criteria of boards' composition• Require credit institutions to establish a diversity policy
Improve ownership by boards of risk strategy	<ul style="list-style-type: none">• Require a declaration on the adequacy of risk management systems• Require a risk statement stating credit institution's approach to risk
Improve priority given by boards to risk issues	<ul style="list-style-type: none">• Require disclosure of policy and practice with regard to discussion and analysis of risk issues during board meetings• Require that boards devote sufficient time to risk issues• Mandatory risk committee at board level
Improve the information flow to boards on risk	<ul style="list-style-type: none">• Require disclosure of policy and practice with regard to the information flow on risk to the board• Require boards to determine the content, format and frequency of risk information it should receive• Require that the risk management function report directly to the board
Improve the standing and the authority of the risk management function	<ul style="list-style-type: none">• Require disclosure of the standing and authority of risk management function• Require an independent risk management function• Require an independent chief risk officer• Require that chief risk officer have appropriate status and authority• Require that removal of the chief risk officer is subject to prior approval by the board
Ensure efficient monitoring of risk governance by supervisors	<ul style="list-style-type: none">• Require that corporate governance is part of supervisory review• Require that the suitability of board members is subject to specific supervisory review• Require supervisors to review agendas and supporting documents for meetings of the board

Source: Executive Summary of the Impact Assessment. Accompanying the document Directive of the European Parliament and the Council (July 2011), European Commission.

7

Other topics





7.1 Systemically Important Financial Institutions

The treatment of systemically important financial institutions (SIFIs) – systemically important banks (SIBs) are a part of them – is currently under discussion at the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS). The objective is to reduce the probability of failure of G-SIBs⁴⁴ by increasing their going-concern loss absorbency and reducing the extent or impact of failure of G-SIBs, by improving global recovery and resolution frameworks. In July 2011 a consultation paper was published by the BCBS dealing with the assessment methodology and additional loss absorbency requirements for such institutions.⁴⁵

For assessing which banks should be considered as G-SIB, an indicator-based measurement approach is proposed where the "selected

indicators are chosen to reflect the different aspects of what generates negative externalities and makes a bank critical for the stability of the financial system."⁴⁶ The indicators reflect the size, the interconnectedness, lack of readily available substitutes for the service provided, global (cross jurisdictional) activity and the complexity of banks and should be assigned with an equal weight of 20% (see Appendix). The assessment is conducted with consolidated group data.⁴⁷

The indicator-based measurement approach can be supported by supervisory judgment based on certain principles. The BCBS also identified several ancillary indicators which can support the supervisory judgment (see Appendix).

The BCBS is of the view that the magnitude of the discussed additional loss absorbency depends on the assessment and the bucket where it resides. A capital surcharge between 1% and 2.5% – to be met with CET1 capital – is currently proposed and it should be implemented through an extension of the capital conservation buffer. It should be phased in along with the capital conservation and countercyclical buffer, i.e., between 2016 and year-end 2018, becoming fully effective on January 1, 2019.

7.2

Overreliance on external ratings

A further objective of the proposed Directive is to reduce the overreliance of institutions and investors on external credit ratings, i.e., on ratings issued by credit rating agencies. This goal can be reached by:

- a) Requiring that all banks' investment decisions are based not only on external ratings but also on their own internal credit opinion; and
- b) That banks with a material number of exposures in a given portfolio develop internal ratings for that portfolio instead of relying on external ratings for the calculation of their capital requirements.⁴⁸

7.3 Small and Medium-Sized Entity

Basel II allows a preferential risk-weight for SMEs compared to other corporates. This beneficial treatment will continue under Basel III.

A more preferential treatment, i.e., lower risk-weights for small and medium-sized entities (SMEs) compared to the current status as suggested from different countries with a SME-based economy, would require a revision to the international Basel framework. According to the proposed EU Regulation, EBA should analyze and report by September 2012 on the current risk-weights, taking into consideration a scenario for a possible reduction by one-third compared to the current situation.⁴⁹

7.4 Basel I limit

With Basel II a limit was introduced requiring that institutions have capital no lower than 80% of the capital that would have been required under Basel I. This limit expired at the end of 2009 but was reinstated until the end of 2011 by the Directive 2010/76/EC (CRD III). The proposed EU Regulation concerning Basel III reinstates it until 2015.⁵⁰

8

Conclusion

The background features a blurred spreadsheet with several data tables and charts. One prominent table has the following data:

8	1800
9	2200
10	1400
11	1221
12	1000
13	1200
14	1400
15	1700
16	2000
17	2200
18	2000

Another table to the right shows values like 18.55, 27.24, and 35.75. Below the tables, there are two charts: a 3D pie chart on the left and a 2D bar chart on the right with a y-axis ranging from 0 to 2500.



1,000
1,100
1,200
1,300
1,400



In response to the serious nature of the recent financial crisis, several measures at the micro and macro level are being considered to increase the stability of the financial markets. One major focus is strengthening global capital and liquidity rules through Basel III. In December 2010, the BCBS published the corresponding Basel III documents (a revised version of the capital framework was published in June 2011).

In the EU, Basel III will be implemented mainly through a Regulation, i.e., the rules are directly applicable at the national level. The European Commission published the proposed Regulation as well as the supplementary Directive in July 2011. These legal instruments are now being discussed within the European Parliament and Council. The new rules would apply as of January 1, 2013, with varying transition periods.

Key aspects of Basel III are: a stricter definition of capital to increase the quality, consistency and transparency of the capital base; introduction of capital buffers; increased capital requirements for CCR; introduction of a leverage ratio to supplement the risk-based framework of Basel II; and a new global liquidity standard introducing two new ratios which banks need to fulfill (LCR and

NSFR). Also included are increased requirements for systemically important financial institutions and strengthening corporate governance.

Even though some of the requirements are still under discussion and need to be specified (e.g., the concrete ASF- and RSF-factors within the NSFR) and others might be recalibrated based on the quantitative impact analysis (e.g., leverage ratio), banks at this time clearly must deal with wide-ranging regulatory changes that will impact their business models and funding strategies as well as capital and liquidity costs. At the same time, pressure continues to mount from a market expecting banks to fulfill or even exceed the new requirements before the regulatory deadline.

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Directive 2010/76/EU of the European Parliament and of the Council of September 16, 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (September 2009), European Parliament and Council found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>

Appendix

Basel III Summary Table

Table 7: Basel III Summary Table

Basel Committee on Banking Supervision reforms – Basel III

Strengthens micro-prudential regulation and supervision, and adds a macro-prudential overlay that includes capital buffers.

Capital Framework

Pillar 1

Capital

Risk coverage

Containing leverage

All Banks

Quality and level of capital

Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions.

Capital conservation buffer

Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range.

Countercyclical buffer

Imposed within a range of 0–2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.

Securitisations

Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures.

Trading book

Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality.

Counterparty credit risk

Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures.

Leverage ratio

A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.

SIFIs

In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global SIFIs. The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. A consultative document was submitted to the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.

Pillar 2

Risk management and supervision

Supplemental Pillar 2 requirements.

Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.

Pillar 3

Market discipline

Revised Pillar 3 disclosures requirements

The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.

Liquidity

Global liquidity standard and supervisory monitoring

Liquidity coverage ratio

The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors.

Net stable funding ratio

The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.

Principles for Sound Liquidity Risk Management and Supervision

The Committee's 2008 guidance entitled Principles for Sound Liquidity Risk Management and Supervision takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations.

Supervisory monitoring

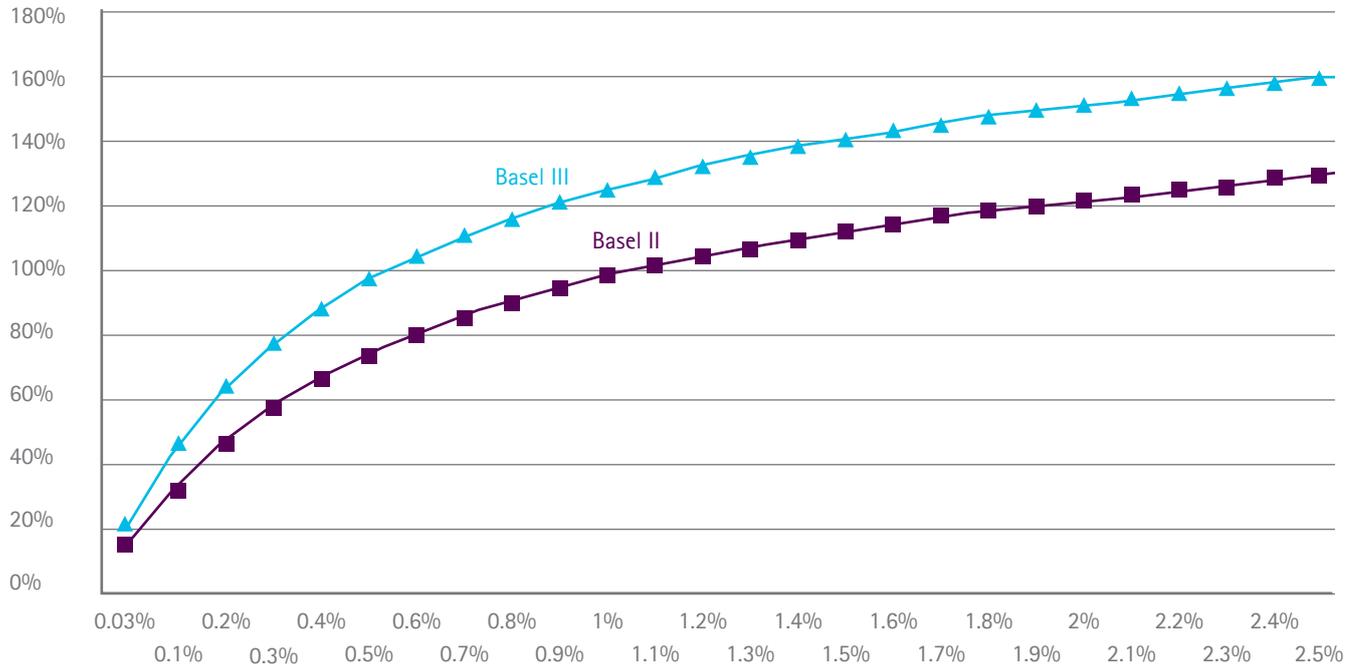
The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.



Asset Value Correlation: Risk-Weight for large financial institutions Basel II vs. Basel III

Figure 13: AVC: Risk-Weights for large financial institutions – Basel II vs. Basel III

Risk-weight



Source: Accenture

Table 8: AVC: Risk-Weights for large financial institutions – Basel II vs. Basel III

PD	RW Basel II	RW Basel III	Increase RW
0.03%	15.31%	20.84%	36.09%
0.10%	31.43%	42.47%	35.12%
0.20%	46.53%	62.22%	33.74%
0.30%	57.64%	76.44%	32.60%
0.40%	66.48%	87.52%	31.64%
0.50%	73.79%	96.52%	30.81%
0.60%	79.98%	104.03%	30.07%
0.70%	85.33%	110.43%	29.41%
0.80%	90.01%	115.94%	28.81%
0.90%	94.15%	120.77%	28.27%
1.00%	97.86%	125.03%	27.77%
1.10%	101.19%	128.82%	27.30%
1.20%	104.23%	132.24%	26.88%
1.30%	107.00%	135.34%	26.48%
1.40%	109.56%	138.16%	26.10%
1.50%	111.93%	140.76%	25.76%
1.60%	114.14%	143.16%	25.43%
1.70%	116.20%	145.39%	25.12%
1.80%	118.15%	147.49%	24.83%
1.90%	119.99%	149.46%	24.55%
2.00%	121.75%	151.32%	24.29%
2.10%	123.42%	153.09%	24.04%
2.20%	125.02%	154.78%	23.81%
2.30%	126.56%	156.40%	23.58%
2.40%	128.05%	157.97%	23.37%
2.50%	129.48%	159.48%	23.16%

Source: Accenture

Indicator-based measurement approach G-SIBS

Table 9: Indicator-based measurement approach G-SIBS

Indicator-based Measurement Approach

Category (and weighting)	Individual Indicator	Indicator Weighting
Cross-jurisdictional activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio	20%
Interconnectedness (20%)	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
Substitutability (20%)	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
Complexity (20%)	OTC derivatives notional value	6.67%
	Level 3 assets	6.67%
	Trading book value and available for sale value	6.67%

Source: Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (July 2011), BCBS, Consultative Document

Table 10: Ancillary indicators for assessment G-SIBS

List of Standardized Ancillary Indicators

Category	Individual Indicator
Cross-jurisdictional activity (20%)	Non-domestic revenue as a proportion of total revenue
	Cross-jurisdictional claims and liabilities as a proportion of total assets and liabilities
Size	Gross or net revenue
	Equity market capitalization
Substitutability	Degree of market participation:
	1. Gross mark-to-market value of repo, reverse repo and securities lending transactions 2. Gross mark-to-market OTC derivatives transactions
Complexity	Number of jurisdictions

Source: Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (July 2011), BCBS, Consultative Document.

Footnotes

1. Basel III: A global regulatory framework for more resilient banks and banking systems (December 2010; rev. June 2011), Basel Committee on Banking Supervision (hereafter "BCBS") of the Bank for International Settlements (hereafter "BIS") found at <http://www.bis.org/bcbs/basel3/compilation.htm> and International framework for liquidity risk measurement, standards and monitoring (December 2010), BCBS. The appendix of this handbook contains a Basel III summary table from BCBS.
2. European Capital Requirements Directive III (2010/76/EU).
3. Principles for Sound Liquidity Risk Management and Supervision (June 2008), BCBS.
4. European Capital Requirements Directive III (2009/111/EC).
5. For Basel III implementation challenges see: Basel III and Its Consequences. Confronting a New Regulatory Environment (2011), Accenture found at http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture_Basel_III_and_its_Consequences.pdf.
6. New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
7. New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
8. European Commission (2011): CRD IV – Frequently Asked Questions, p. 15 (<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/527&format=HTML&aged=0&language=EN&guiLanguage=en>).
9. For the following descriptions see New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
10. Article 26 of the proposed EU Regulation [Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms] (European Commission, July 2011).
11. European Commission (2011): CRD IV – Frequently Asked Questions.
12. Proposed EU Regulation [Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms] (European Commission, July 2011).
13. Relevant entities according to the EU proposed Regulation are: (a) another institution; (b) a financial institution; (c) an insurance undertaking; (d) a third country insurance undertaking; (e) a reinsurance undertaking; (f) a third country reinsurance undertaking; (g) a financial undertaking; (h) a mixed activity insurance holding company; (i) an undertaking excluded from the scope of Directive. See New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
14. See European Commission (2011): CRD IV – Frequently Asked Questions (<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/527&format=HTML&aged=0&language=EN&guiLanguage=en>).
15. Article 108(7) of the proposed EU Regulation [Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms] deals with the calculation of risk-weighted exposure amounts with regard to counterparties with which the institution has entered into an institutional protection scheme that is a contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary.
16. For the following explanations see New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
17. For more details about the calculation see Article 131 of the proposed EU Directive.
18. See also Bundesbank (May 2011): Basel III – Leitfaden zu den neuen Eigenkapital- und Liquiditätsregeln für Banken.
19. European Commission (2011): Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate; p. 12.
20. Calibrated in increments of 0.25 percentage points, or multiples of .25.
21. The directive allows also a buffer beyond 2.5 if justified.
22. Basel III: A global regulatory framework for more resilient banks and banking systems (December 2010; rev. June 2011), BCBS as well as New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
23. Basel III: A global regulatory framework for more resilient banks and banking systems (December 2010; rev. June 2011), BCBS, p. 38.
24. According to the proposed EU Regulation [Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms] unregulated financial entity means any other entity that is not a regulated entity but performs one or more of the listed activities.
25. European Commission (2011): Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate; p. 15.
26. For the following descriptions see New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
27. During the period from Jan. 1, 2013 to Dec. 31, 2017 competent authorities may permit institutions to calculate the end-of-quarter leverage ratio where they consider that institutions may not have data of sufficiently good quality to calculate a leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.
28. For explicitly mentioned off-balance-sheet items, there are exceptions to this treatment.

29. Principles for Sound Liquidity Risk Management and Supervision (September 2008), BCBS.
30. For the following descriptions see New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm
31. See Article 7(1) of the proposed Regulation; for cross border institutions also Article 7(2).
32. Article 401 of the proposed Regulation.
33. Bonds are issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders [Directive 2009/65/EC of the European Parliament and the Council, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF>].
34. According to the proposed EU Regulation [Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms] retail deposit means a liability to a natural person or to a small and medium sized enterprise where the aggregate liability to such clients or group of connected clients is less than 1 million EUR.
35. See Article 408(2) of the proposed EU Regulation [Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms].
36. In the Basel III document from the Basel Committee on Banking Supervision "> 100%" is proposed.
37. Basel III: International framework for liquidity risk measurement, standards and monitoring (December 2010), BCBS.
38. Basel III: International framework for liquidity risk measurement, standards and monitoring (December 2010), BCBS.
39. Metrics suggested: a) Funding liabilities sourced from each significant counterparty/ the bank's balance sheet total; b) Funding liabilities sourced from each significant product/instrument/ the bank's balance sheet total; c) List of asset and liability amounts by significant currency.
40. Note: Amount of total net foreign exchange cash outflows should be net of foreign exchange hedges.
41. For the following descriptions see European Commission (2011) – Commission Staff Working Paper: Executive Summary of the Impact Assessment. Accompanying the document Directive of the European Parliament and the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/executive_summary_IA_directive_en.pdf).
42. See New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
43. For the following descriptions see European Commission (2011) – Commission Staff Working Paper: Executive Summary of the Impact Assessment. Accompanying the document Directive of the European Parliament and the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/executive_summary_IA_directive_en.pdf).
44. Global systemically important banks.
45. See hereto and for the following descriptions Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (July 2011), BCBS, Consultative Document.
46. Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (July 2011), BCBS, Consultative Document, p. 3.
47. For more details see Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (July 2011), BCBS, Consultative Document.
48. See CRD IV – Frequently Asked Questions (2011), European Commission.
49. New proposals on capital requirements (July 2011), European Commission found at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.
50. See European Commission (July 2011): New proposals on capital requirements; http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

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