

# Basel Committee proposals for ‘Strengthening the resilience of the banking sector’

New rules or new game?



On 17 December, the Basel Committee on Banking Supervision released two consultation papers with proposals for strengthening global capital and liquidity regulations with the goal of promoting a more resilient international banking sector.

Together with the Basel II enhancement package issued in July 2009, these proposals form part of the Committee's response to the lessons learnt from the financial crisis. The reforms have been endorsed by the Financial Stability Board and the G20 leaders at their Pittsburgh Summit.

The reforms will fundamentally impact the profitability and business models of many banks, as well as mandating significant process and systems changes.

# “Comprehensive response to the global financial crisis” Proposals of the Basel Committee on Banking Supervision to promote a more resilient international banking sector

## Introduction

Following its meeting in September 2009, the Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee, announced a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector. At its meeting on 8 and 9 December 2009, the Basel Committee agreed on concrete steps for implementing the announced measures. Two consultation papers setting out the proposals were released on 17 December:

- **“Strengthening the resilience of the banking sector”**; and
- **“International framework for liquidity risk measurement, standards and monitoring”**

This document provides a summary of the regulatory proposals included in the two consultation papers as well as PricewaterhouseCoopers' first reactions as to the possible implications of the new rules. Over the coming months, we will develop more detailed points of view on individual aspects of these proposals.

The Basel Committee's proposals focus on improving global regulation in the areas of capital and liquidity. The measures include:

- Micro-prudential supervisory measures aimed at improving the resilience of individual institutions to shocks arising from financial and economic stress (such as raising the quality and quantity of capital and liquidity buffers);
- Macro-prudential measures to improve the resilience of the global banking system as a whole (such as countercyclical capital buffers and steps to address systemic risks).

### The proposals include:

- Raising the quality, consistency and transparency of the capital base through stricter rules on eligibility of instruments to be included in (core) Tier 1 capital;
- Enhancing risk coverage through 'strengthening' counterparty credit risk capital requirements arising from derivatives, repurchase transactions and securities financing;
- Supplementing risk-based capital requirements with a non-risk-based leverage ratio;
- Reducing procyclicality and promoting countercyclical capital buffers through a combination of forward-looking provisioning and capital buffers;
- Introducing a global liquidity standard comprising a stressed liquidity coverage ratio and a longer-term structural liquidity ratio; and
- Addressing systemic risk and interconnectedness with more specific proposals to be developed in the first half of 2010.

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### Important dates of the consultation process

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- Consultation period for both sets of proposals runs until 16 April 2010
  - Comprehensive Impact Assessment to be carried out during the first half of 2010
  - Development of a fully calibrated set of standards by end 2010
  - Implementation expected by end 2012 (including phase-in measures and grandfathering arrangements)
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## Capital base

The following sections provide further detail on each of the proposals.

The Basel Committee is proposing a number of measures to raise the quality, consistency and transparency of the available capital base, with three main areas of focus:

- Requiring harmonised regulatory adjustments to be made from common equity;
- Conforming the list of regulatory adjustments and their treatment across territories; and
- Requiring more detailed public disclosures of regulatory capital bases.

The predominant part of Tier 1 capital should be common equity; for joint stock companies this comprises common shares and retained earnings. For companies such as mutuals and cooperatives, which are not shareholder-owned, adequate principles will be developed to ensure an equivalent quality of Tier 1 capital.

Deductions from capital (e.g. for goodwill and intangibles, minority interests, pension and deferred tax assets, and the shortfall of provisions to expected losses for IRB institutions) as well as prudential filters are to be harmonised on a global basis and will be applied entirely to common equity.

For instruments other than common equity to be included in Tier 1, specific criteria are introduced to ensure these absorb losses on a going-concern basis. In particular, this will mean that innovative Tier 1 instruments will be phased out.

In addition, the Committee has announced a simplification of the criteria for instruments to be included in Tier 2 capital, as well as the abolition of Tier 3 capital, which is currently available to cover market risk requirements.

In order to improve transparency and market discipline with respect to regulatory capital, all components of capital will need to be disclosed, with a separate disclosure of all adjustments as well as a reconciliation of regulatory capital elements back to the audited financial statements.

## Risk coverage

The need to strengthen risk coverage of the Basel framework has been one of the key lessons of the financial crisis. To this end, the Basel Committee issued the revised capital requirements for trading book exposures and complex securitisation transactions in July 2009.

The new proposals focus on strengthening capital requirements for counterparty credit risk (CCR) arising from derivatives, repo and securities financing activities.

The enhancements to the framework are designed to raise capital buffers backing these exposures, reduce procyclicality and provide additional incentives to move OTC derivative contracts to central counterparties and exchanges.

In particular, they require banks to determine capital charges for CCR using stressed inputs, similar to the approach used for determining stressed VaR for market risk. In addition, a capital charge for mark-to-market losses (i.e. credit valuation adjustment or CVA risk) is introduced, along with additional collateral and margin requirements for illiquid derivative transactions and higher capital charges for bilateral OTC exposures to financial institutions.

## Leverage ratio

One of the causes of the financial crisis was the build-up of excessive leverage in the banking sector. The Basel Committee is now proposing to introduce a volume-based, leverage ratio (which is not risk-adjusted) to complement the risk-based minimum capital requirements under Pillar 1 of the capital adequacy framework.

The ratio is designed to put a cap on the build-up of leverage in the banking system as well as to introduce additional safeguards against model risk and measurement errors by supplementing the risk-based capital requirements with a simple, transparent measure of leverage.

In order to ensure international comparability of the leverage ratio, which is initially intended to be used under Pillar 2 of the framework with a view to migrating it into Pillar 1 in the future, it will be adjusted for differences in accounting standards.

## Countercyclical capital buffers

The procyclical amplification of financial shocks across the financial system and the wider economy has been one of the most destabilising elements of the financial crisis.

The Committee proposes a series of measures – in addition to the leverage ratio – to address procyclicality and create additional shock absorbers in the financial system. These measures are designed to dampen excess cyclicality, promote forward-looking provisioning, conserve capital to be available during periods of stress, and protect the banking sector from periods of excess credit growth.

In order to reduce the cyclicality of minimum capital requirements under Pillar 1, the Committee proposes to use a 'downturn Probability of Default' (PD) (similar to the existing requirement of downturn Loss Given Default) in the capital calculations. The impact study in 2010 will test at least two different proposals for deriving such downturn PD estimates.

As an additional measure, the Basel Committee promotes stronger provisioning practices by advocating a change of accounting standards towards an expected loss approach in order to capture actual losses more transparently and be less procyclical than the current 'incurred loss' approach to provisioning. In this regard, the Committee is working closely with the International Accounting Standards Board (IASB) as it works on the replacement of IAS39.

The Committee is also proposing measures to conserve capital and create buffers in 'good times' that can absorb shocks in periods of stress. The framework envisages capital distribution constraints when capital levels fall within a specified range above minimum requirements, with the constraints increasing the closer a bank's capital levels get to the minimum.

Complementing the buffer mechanism applied at individual bank level, the Committee also proposes a macro-prudential approach that would adjust the capital buffer ranges to counteract excessive credit growth.

## Systemic risk

The interconnectedness of international banks supports economic growth but in times of stress transmits negative shocks across the financial system and the economy. The Committee is developing policy options designed to reduce risks related to the failure of systemically relevant, cross-border institutions. These include the possible introduction of a capital and/or liquidity surcharge for these institutions. The Committee's work is part of a wider effort of the Financial Stability Board to address the risk of systemically important institutions. More detailed proposals will be issued during the first half of 2010.

## Liquidity

In its second consultation paper, 'International framework for liquidity risk measurement, standards and monitoring', the Basel Committee proposes a strengthened liquidity framework, which – in addition to the qualitative 'Principles for Sound Liquidity Risk Management and Supervision' issued in 2008 – introduces quantitative standards for funding liquidity. The two proposed measures are a 30-day liquidity coverage ratio designed to ensure short-term resilience to liquidity disruptions and a longer-term structural liquidity ratio to address liquidity mismatches and promote the use of stable funding sources.

Furthermore, the Committee proposes a set of monitoring metrics to assist supervisors in the analysis of bank-specific and system-wide liquidity risk trends.

## More stringent than originally anticipated

A first assessment would suggest that the Basel Committee's proposals are more punitive than originally anticipated. Each institution will be affected differently, but below are some possible impacts:

- Technical changes to the definition of available capital are likely to push many banks to raise more capital, for example:
  - The emphasis will be on the (more expensive) core Tier 1 equity as against other less permanent instruments.
  - The proposed deduction of minority interest comes as somewhat of a surprise and could result in significant reductions in available capital.
  - Few regulators currently deduct deferred tax assets. Deductions will become mandatory for all. In some jurisdictions, where banks have booked significant losses and taken some credit for tax recoverable on these, the deduction of deferred tax assets could have a very significant impact.
  - Harmonisation of deductions for stakes in financial institutions such as insurance businesses may well result in increased capital needs in bancassurers.
- Perhaps the most severe impact could result from the additional capital charges introduced for various aspects of counterparty credit risk (which were something of a surprise). The combined effect of capitalising CVA risk, extending the time horizon for collateral margining on securities finance and OTC derivatives and increasing the asset correlation for exposures to financial institutions could have significant implications for banks with large derivative operations. These impacts will be compounded by the proposals for liquidity risk, particularly as they relate to fixed income trading.
- There are likely to be major implementation challenges, requiring significant expenditure on methodologies and systems (including a further integration between market and credit risk data, tools and infrastructure). These come on top of initiatives that investment banks and other institutions with trading portfolios are undertaking to prepare for the changes in the trading book regime and to respond to shortcomings in their data and systems infrastructure identified during the crisis.
- As far as countercyclical capital buffers and expected loss provisioning approaches are concerned, the proposals provide very little detail to enable banks, analysts and investors to assess the impact of the rules. The interaction with changes in accounting standards – and the implicit objective to align regulatory and accounting rules in this area – further complicates the situation. This results in a potentially long period of continued regulatory uncertainty, which creates difficulties for longer-term strategic (and capital) planning and the development of strengthened supervision at supervisory authorities. However, the combination of these regulatory changes with a market expectation for a higher level of capital is likely to increase capital needs, reduce returns and dampen growth.
- The suggested formulation of the leverage ratio could require the inclusion of derivative and repo exposures on a gross basis without allowing for netting (effectively using the IFRS rather than US GAAP accounting treatment). This could significantly restrict business expansion of investment banks.
- Levels of liquidity have been a major area of concern for the last two years and to deal with this new regime pushes banks towards holding greater levels of liquid instruments such as government bonds and more liquid corporate instruments. This will result in a quantifiable cost to banks, particularly if this new regime increases overall demand for such instruments. Further, banks will need to work with regulators to develop an approach that does not lock liquid assets in separate pools in the various countries in which they operate. A too-strict definition of eligible instruments could also result in pricing anomalies, particularly in government bond markets.

In summary, the proposals point to an intention on the part of regulators to use capital and liquidity requirements to push banks back from businesses that are perceived as generating cost to society and to the public purse. They mark a fundamental shift by regulators from oversight to a deliberate attempt to shape banking behaviour. For banks, the regulators intend a future of more capital, more liquidity and less risk; as a result they face a lower return on capital and slower growth. The timing of the introduction of these changes needs to be handled very carefully in light of the fragility of the emerging economic recovery in developed economies.

The complexity of the proposals, the risks of unintended consequences, and the interaction between these and other developments place a strong burden on the industry to assess the impacts carefully and ensure that the right balance is achieved between risk management and economic well-being.

The implementation of the latest proposals – which in the European Union will involve a European Directive and its transposition into national legislation – will be complex. The financial crisis has resulted in what some commentators have called a 'tsunami' of supervisory recommendations and guidelines. It will be challenging for institutions to maintain an overview of the changing environment at all levels of implementation, while at the same time analysing and assessing the impact of the proposed changes on their business models and infrastructure.

The quantitative impact assessment announced for 2010 will be a major exercise in terms of detailed data requirements and the complexity resulting from the large number of interconnected proposals.

To conclude, these are only proposals and the precise impact remains uncertain, However, the issue is not "if", but "how much?" The calibration of the system during 2010 is critical, both for the regulators and the banks.

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