

**Briefing on proposed BIS changes to Basel II in the wake of the banking crisis**

(See Consultative Document: ‘Strengthening the resilience of the banking sector.’

Issued December 2009 BIS for comment by 16 April 2010. [www.bis.org](http://www.bis.org))

- The document contains 5 specific proposals to improve the resilience of the international banking system to financial and economic shocks. The committee does not expect that its proposals will significantly increase capital requirements of international banks over the levels in operation today. Rather they see the proposals as codifying and making permanent the ad-hoc improvements in the quality and amount of capital held by banks made as a response to the recent banking crisis.
- The effect of the changes, if implemented, will be:
  - to increase the amount of Tier 1 capital (especially common stock) needed to conduct business;
  - to increase the risk weights attached to counterparties and instruments;
  - to reduce the collateral value of a number of instruments;
  - to make OTC trading more expensive and trading via exchanges and CCPs relatively more attractive;
  - to increase the amount of liquid capital available to banks without winding up major parts of their businesses.
- The details of the five proposals are as follows:

**1. The quality, consistency, and transparency of the capital base will be raised**

This will ensure that large, internationally active banks are in a better position to absorb losses on a ‘going concern’ as well as in the case of default. The concerns of the Committee were as follows:

- a. Under current Basel II rules, banks could hold as little as 2% common equity to risk-weighted assets. As a consequence, it has been possible for some banks under the current standard to display strong Tier 1 ratios with limited tangible common equity
- b. There are inconsistencies in the definition of capital across jurisdictions and a lack of disclosure preventing the market from fully assessing and comparing the quality of capital between institutions. The Committee therefore proposes to strengthen that component of the Tier 1 capital base which is fully available to absorb losses without liquidating the bank
- c. The Committee propose that a framework should be developed which focuses more specifically on common equity rather than the wider Tier 1 capital. This move is motivated by three concerns:
  - i. That the wider Tier 1 measure has come into disrepute as it may include illiquid instruments or instruments callable at short notice
  - ii. The current Tier 1 rules are more focussed on ensuring sufficient compensation in the case of default rather than ensuring adequate capital for continued operation
  - iii. The current framework has no mechanism for regulatory adjustment at the level of common equity rather than the level of Tier 1 capital
- d. The proposal is that common shares and retained earnings<sup>1</sup> must be the predominant form of Tier 1 capital and there will be an explicit minimum for common equity in Tier I. The remainder of the Tier 1 capital base must be instruments that are subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem
- e. Goodwill and other intangibles must be deducted from the Common Equity component of Tier 1 capital, as must investments in own shares,<sup>2</sup> or shares of other financial institutions where the holding of the bank is more than 10% of the common shares of that financial institution<sup>3</sup>
- f. Innovative hybrid capital instruments with an incentive to redeem through features like step-up clauses<sup>4</sup> (currently limited to 15% of the Tier 1 capital base) will be phased out.
- g. Criteria for acceptability in Tier 2 will be harmonised. All Tier 2 capital will need to meet the minimum standard of being subordinated to depositors and general creditors and have an original maturity of at least 5 years

<sup>1</sup> Or equivalent, for non-common stock companies.

<sup>2</sup> Banks must look through investments in index stocks to eliminate any exposure to its own shares.

<sup>3</sup> Shares held as part of cross-holding agreements with ‘sister’ companies are not allowable.

<sup>4</sup> ‘Step-up clauses’ are arrangements to increase the interest rates on a security after a period of time. Thus even though redemption may be solely at the discretion of the issuer there is a pressure for redemption at certain times.

- h. The requirement that Tier 1 capital must always be greater than or equal to Tier 2 capital will be withdrawn
- i. So-called Tier 3 capital instruments, which were only ever available to cover market risks, will be eliminated<sup>5</sup>
- j. The transparency of the capital base will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts.

## 2. The risk coverage of the capital framework will be strengthened

The Committee is proposing to strengthen the capital requirements for counterparty credit risk, especially exposures arising from derivatives, repos, and securities financing activities. The strengthened counterparty capital requirements are designed to increase incentives to move OTC derivative exposures to central counterparties and exchanges. The reasons for this are as follows:

- i. Deterioration of credit valuations and market volatility have been clearly shown to be linked
- ii. Mark-to-market valuations have not been adequately capitalised<sup>6</sup>
- iii. Large financial institutions have been shown to be more interconnected than non-financial firms and this has not been adequately reflected in the capital framework
- iv. The close-out period for replacing trades with a counter-party with large or complex netting sets extended beyond the capital horizon for capital calculations
- v. Initial margining going into the crisis was very low and sudden large margin calls precipitated defaults
- vi. Use of CCPs was too limited
- vii. Valuations and risk assessments of securitised instruments were too optimistic.

The Committee has resolved therefore that capital requirements for trading book and securitisation exposures will be raised by the following measures:

- a. An additional<sup>7</sup> VaR treatment is required based on a 12 month period of significant financial stress. (e.g. 2007-8)
- b. Higher capital requirement for resecuritisations<sup>8</sup> in banking and trading book – doubling of supervisory haircuts for resecuritised instruments and eliminating their use as allowable collateral
- c. Increase in the minimum margin period of risk to 20 days for large netting sets or those containing illiquid collateral
- d. Improved disclosure
- e. Increased haircut minima for non-cash collateral<sup>9</sup>

<sup>5</sup> These changes to capital structure will mean that for any risk weighted exposure a bank will have to demonstrate it exceeds three ratios: x% common equity, y% Tier 1 capital, z% total capital. The percentages to be set after consultation.

<sup>6</sup> 66% of banks' losses in the recent crisis were due to credit valuation adjustments rather than defaults.

<sup>7</sup> The text indicates that this stressed VaR will be added to the existing market VaR rather than replace it. This seems to be overkill by the regulators and we may see this reduced in the final draft.

<sup>8</sup> Resecuritisation is the practise of bundling securitised assets and re-issuing the bundled security. The re-issued security may have additional credit enhancement or be issued in tranches with different risk characteristics. The security is collateralised by the securitised paper, e.g. an ABS. A bank retaining a portion of a securitised issue might expect to double the amount of capital it needs to apply to the position under the proposed rules.

<sup>9</sup> This will in effect reflect and codify the new market practices of higher haircuts which have come into being since the crisis.

Issue Rating	Residual Maturity	Haircut %	
		Sovereigns	Other Issuers
AAA to AA-/A-1	<1 year	0.5	1
	>1 year <5 years	2	5
	> 5years	4	8
A+ to BBB-/A-2/A-3/P-3 and unrated bank securities	<1 year	1	2
	>1 year <5 years	3	6
	> 5years	6	12
-BB to BB+	all	15	Not eligible
Main index equities		15	
Other equities		25	
UCITS/Mutual Funds	Highest haircut applicable to any component equity		
Cash (same Currency)		0	

- f. Banks must determine their capital requirement for counterparty credit risk using stressed inputs
- g. Banks will be subject to a capital charge for mark-to-market losses<sup>10</sup>
- h. Banks with large illiquid derivative positions will have to use longer margining period.
- i. Exposures to large financial entities will attract a multiplier of 1.25 when calculating capital requirement
- j. Banks' collateral and mark to market exposures to CCPs and exchanges meeting the criteria of CPSS/IOSCO<sup>11</sup> will qualify for a 0% risk weight<sup>12</sup>
- k. Strengthened capital requirement for bi-lateral OTC exposure
- l. Increased risk weights for exposures to non-financial entities
- m. Reduction of reliance on external credit agency ratings.<sup>13</sup>

### 3. A supplementary leverage ratio to the Basel II risk-based framework will be introduced

This will help contain the build up of excessive leverage in the banking system, introduce additional safeguards against attempts to game the risk based requirements, and help address model risk. The intention is to prevent the pernicious feedback effect of banks suddenly reducing leveraged positions and so depressing asset prices; hence forcing further reductions in leverage.

- a. A leverage ratio (supplementary to the standard risk based requirement) will be enforced. Certain off-balance sheet items would be included using a flat 100% credit conversion factor
- b. The calculation of the leverage ratio is yet to be completed.

### 4. Measures will be introduced to promote the build up of capital buffers

These may be drawn upon in periods of stress together with more forward looking provisioning based on expected losses. These measures will mitigate the ingrained tendency of financial markets and the banking system to pro-cyclicality.<sup>14</sup>

- a. In addition to existing measures to counter pro-cyclicality (e.g. long term horizons for LGD estimates) the Committee is conducting an impact study on two specific proposals for improving default predictions with a view to deploying an appropriate approach:
  - i. The first is based on the use of the highest average PD estimate applied by a bank historically to each of its exposure classes as a proxy for a downturn PD
  - ii. The second is based on the use of an average of historic PD estimates for each exposure class
- b. The Committee also requires that banks conduct stress tests that consider the downward migration of their credit portfolios in a recession
- c. The Committee is promoting stronger provisioning practices through three related accountancy approaches:
  - i. It is advocating a change in the accounting standards towards an expected loss (EL)<sup>15</sup> approach
  - ii. It is updating its supervisory guidance to be consistent with the move to such an EL approach. Such guidance will assist supervisors in promoting strong provisioning
  - iii. It intends to remove disincentives to stronger provisioning in the regulatory capital framework. To promote the conservation of capital and discourage the distribution of excessive dividends the Committee is proposing to introduce a framework that will give supervisors stronger tools to promote capital conservation in the banking sector
  - iv. It proposes that 100% of provisioning will be from the common stock portion of Tier 1 capital rather than 50% from Tier 1 and 50% from Tier 2 as at present.

<sup>10</sup> *i.e CVA risk. Credit Valuation Risk caused by deterioration in the credit worthiness of counterparty and has been a greater source of loss in the recent banking crisis than counterparty default. These losses have been exacerbated by the growth of credit derivatives triggered by non-default events. CVA risk is not addressed by the current Basel II regulations which are concerned only with the default risk.*

<sup>11</sup> *Committee on Payment and Settlement Systems and International Organization of Securities Commissions*

<sup>12</sup> *Contributions to the guarantee fund will continue to attract a risk weight although the Committee will consider applying simplified risk weights for such exposures to the guarantee fund in the future.*

<sup>13</sup> *Banks must perform their own internal credit assessments of securitisation exposures.*

<sup>14</sup> *In this context we are referring to the build up of leveraged investments in good times followed by the sudden release of these investments into the markets as the economic cycle changes.*

<sup>15</sup> *IASB is considering a move from approaches based on Incurred Loss to those based on Expected Loss (EL). There is currently considerable resistance to the change due to the difficulty in operationalising such approaches and the difficulty of accurately forecasting losses.*

- d. The Committee is developing proposals which would adjust the capital buffer range. The proposal is currently at an earlier stage of development and the Committee will review a concrete proposal at its July 2010 meeting
- e. When the capital conservation range is set a bank, which is seen to be close to the minimum of the range in year 1, must retain a minimum percentage of profits in year 2<sup>16</sup>
- f. Other than the related measures to increase the capital buffer mentioned above there is currently no intention to limit credit growth in normal times.

**5. A global minimum liquidity standard will be introduced for internationally active banks**

This will include a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio.

- a. In addition to the restatement of the ‘*Principles for Sound Liquidity Risk Management and Supervision*’ which it published in 2008 the committee *is proposing two* minimum standards for funding liquidity:
  - i. A 30-day liquidity coverage ratio to promote short-term resilience to potential liquidity disruptions
  - ii. A longer-term structural ratio to address liquidity mismatches and provide incentives for banks to use stable sources to fund their activities
- b. Additionally a set of monitoring metrics will be introduced to improve cross-border supervisory consistency.

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<sup>16</sup> By way of illustration: if the conservation range for a bank was £100 billion to £120 billion and if holds £110 Billion of Capital at the end of year 1, it might be forced to retain 60% of its profits in the subsequent year; but if it holds only £105 billion of capital it might be forced to retain 100% of its profits.