Basel III och påverkan på banksektorn

Nov 17, 2010
Transmission of financial crisis to the real economy

- Excessive on- and off-balance sheet leverage
- Procyclical deleveraging of banks exacerbated negative effects of financial and RE crisis on the real economy
- Interconnectedness of systemic institutions through an array of complex and sometimes non-transparent transactions
- Insufficient liquidity buffers of most financial institutions, which ultimately turned to central banks for refinancing
- Low capitalisation, thin equity cushions, deteriorating quality of banks’ capital sources
- Resulting inability to absorb increasing trading and credit losses nor to re-intermediate large off-balance sheet exposures

Source: J.P. Morgan
Basel III regulation
Basel III capital requirements

Key concepts

- **Minimum capital requirement of common equity**
  - Under the current Basel accord, the minimum common equity capital requirement is 2.0% of risk-weighted assets (RWA).
  - The Basel III minimum requirement will increase to 4.5% of RWA.
  - The total minimum Tier 1 capital (common equity + other financial instruments) will also increase from 4.0% to 6.0% of RWA.

- **Capital Conservation buffer**
  - In addition to the minimum requirement, Basel III introduces a capital conservation buffer of 2.5%, consisting of common equity.
  - While banks are allowed to draw on the conservation buffer during periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions.
  - In effect, the common equity buffer increases from 2.0% under the current regime to 7.0% under Basel III.

- **Countercyclical buffer**
  - A countercyclical buffer within a range of 0% – 2.5% of common equity or other fully loss absorbing (Tier 1) capital will be implemented according to national circumstances.
  - The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.

- **Addition for systemically important banks**
  - Systemically important banks may need to have additional loss absorbing capacity beyond the above requirements, which could include combinations of capital surcharges, contingent capital, and bail in debt.

- **The minimum total Tier 1 + Tier 2 capital requirements will remain at 8.0%**

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**Diagram:**

- Current rules vs. New rules (Sept 10)
- Regulatory minimum capital (Sr)
- **Regulatory minimum capital (%):**
  - **Current rules:**
    - Common equity: 2.0%
    - Tier 1 capital: 4.0%
    - Total capital: 8.0%
  - **New rules:**
    - Common equity: 4.5%
    - Tier 1 capital: 6.0%
    - Total capital: 8.0%

**Legend:**
- Countercyclical buffer
- Conservation buffer
- Minimum capital requirement

**Notes:**
- Common Tier 1 Capital must be Common Equity.
Gradual phase-in of capital requirements

Still a proposal and unclear when it will start to apply
Impact on capital
Change in capital ratios and standing post implementation

Estimated change in pro forma capital ratios under new Basel proposals for a sample of European Banks

Core Tier 1 ratio = Core tier 1 capital (≈ equity) / RWAs

Source: Bank Financial Reports, Basel Committee Consultative Document; BNP Paribas
Balance Sheet Structure

Off-balance sheet commitments and contingent liabilities

Assets

- Cash & Lending Financial Institutions
- Net Trading Assets
- Bond Liquidity Portfolios
- Household Lending
- Other Lending

Equity & Liabilities

- Deposits Financial Institutions
- Funding <1 year
- Funding, remaining maturity >1 year
- Deposits from the public
- Equity

Funding,
remaining maturity >1 year

"Banking book"

Liquid assets

Short-term funding

Stable funding

Short-term funding

Stable funding

Off-balance sheet commitments and contingent liabilities
Basel III new requirements
Introducing additional constraints

**Leverage ratio**

<table>
<thead>
<tr>
<th>Capital</th>
<th>≥ 3%</th>
</tr>
</thead>
<tbody>
<tr>
<td>On and off-balance sheet exposures</td>
<td></td>
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</tbody>
</table>

- Introduce a "non-risk based" leverage ratio as a supplementary measure to the risk based Basel II framework
- Capital = Tier 1 capital
- Exposure = accounting measure on-balance and significant amount of off-balance sheet exposures (unutilised commitments etc)
- Binding from 2018, reporting and monitoring from 2011

**Liquidity Coverage ratio**

<table>
<thead>
<tr>
<th>Stock of high quality liquid assets</th>
<th>≥ 100%</th>
</tr>
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<tbody>
<tr>
<td>Net cash outflows over a 30-day time period</td>
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</tbody>
</table>

- Ensure a bank has sufficient high quality liquid resources, immediately convertible into cash at no or little loss, to survive an acute stress scenario defined by supervisors and lasting for 30 days
- Stock of high quality liquid assets: - AAA gov bonds and and to some extent covered bonds and AA-rated corp bonds
- Net cash outflows: sum of the bank’s liabilities expected to roll-off during the 30-day stress period and the estimated draw-downs on off-balance sheet commitments

**Net Stable Funding ratio**

<table>
<thead>
<tr>
<th>Available amount of stable funding</th>
<th>≥ 100%</th>
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<tbody>
<tr>
<td>Required amount of stable funding</td>
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- Ultimately ensure banks have adequate ALM practices in place to weather through a prolonged credit crisis
- Banks will be required to increase their portion of long-term funding, or at least to align their liabilities’ maturity profile to the one of their assets
- *De facto* the ratio implies that assets which cannot be converted into cash within a 1-y horizon have to be funded via stable medium/long-term liabilities
Liquidity requirements
Net stable funding ratio minimum

**Net stable funding ratio**
- Establishes a minimum acceptable amount of stable funding based on liquidity characteristics of on- and off-balance sheet exposures and activities over a 1 year horizon
  - Based on liquidity risk factors assigned to assets and off-balance sheet exposures
- Defined as:
  \[
  \frac{\text{Available Stable Funding ("ASF")}}{\text{Required Stable Funding ("RSF")}} > 100\%
  \]
- **ASF** comprised of:
  - Capital
  - Preferred stock with maturity >=1yr
  - Liabilities with effective maturities of >=1yr
  - Portion of "stable" non-maturity / term deposits with maturities <1yr expected to stay with the Bank for extended period in the stress event
- **RSF** calculated as a sum of:
  - The value of assets held and funded x RSF factor assigned to each asset type and
  - Off-balance sheet exposures multiplied by its associated RSF factor

<table>
<thead>
<tr>
<th>Composition of available and required stable funding</th>
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<tbody>
<tr>
<td><strong>RSF Components</strong></td>
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<tr>
<td>--------------------</td>
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<tr>
<td>Cash &amp; equivalents</td>
</tr>
<tr>
<td>Reverse repos</td>
</tr>
<tr>
<td>Securities and loans to financials with mat. &lt;1 yr</td>
</tr>
<tr>
<td>Unencumbered corp. bonds with maturity &gt;1 yr, and AA rating</td>
</tr>
<tr>
<td>Equities included in a large cap market index</td>
</tr>
<tr>
<td>Non-financial senior bonds with A rating / loans with maturity of &lt;1 yr</td>
</tr>
<tr>
<td>Leases to retail clients with maturity &lt;1 yr</td>
</tr>
<tr>
<td>Other off-balance sheet assets</td>
</tr>
<tr>
<td>Off-balance sheet exposures – conditionally receivable and irrevocable credit and liquidity facilities</td>
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</table>
Indicatively Nordic banks will not meet the requirement that the Net Stable Funding Ratio must be greater than 100%

Main Drivers Explaining the Deficit

i. The loan book has a longer contractual duration than deposits
ii. Different (unfavorable) haircuts for loans and deposits with maturity < 1 yr
iii. Stable funding (> 1 yr) required for bonds and equities range from 5 to 100%

Source: Deutsche Bank and SEB
Current Basel III status

- Piecemeal release of details does not allow a full assessment of its combined effects
- "Buffer-upon-buffer" approach runs counter to Pillar 2 philosophy
- Still no clarity about final shape/calibration of liquidity proposals
  - Re-calibration of stress for the LCR (although it has been announced that agreement was reached)
  - Definition of eligible assets for countries with insufficient "level 1" assets (many emerging markets, but also Australia, South Africa and some European countries)
- New approach to calculation of CVA capital charge not finalised
- Apparently long transition periods which are likely to be shorter for many banks due to peer and market pressure
- No "official" impact analysis (QIS results)
- Political agreement (G20) came in November with final Basel package to be published shortly thereafter (December)

Source: PwC
Trends affecting banking

Key elements of Basel III
- Improve the quality, consistency and transparency of the capital base
- Strengthen capital requirements for counterparty exposures arising from derivatives, repos and securities financing transactions
- Introduce a leverage ratio as a supplementary measure to the risk based Basel II framework
- Promote building up capital buffers in good times to be drawn upon in periods of stress
- Introduce global minimum liquidity standards in the form of a Liquidity Coverage Ratio and a Net Stable Funding Ratio

Overall impact of Basel III
- Banks’ cost of capital and funding will increase
- Banks’ capacity to lend, especially long-term, will decrease
- Demand for household and corporate deposits will increase
- Second-round effects from reduced lending and reduced maturity transformation capacity will impact real economy
- Customer financing costs will likely increase
- Supply of credit may be constrained
- Increased attractiveness of bond markets for better rated corporate

<table>
<thead>
<tr>
<th>Influence</th>
<th>From</th>
<th>To</th>
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<tbody>
<tr>
<td>Macroeconomics</td>
<td>High growth / exuberant</td>
<td>Low growth / subdued</td>
</tr>
<tr>
<td>Government</td>
<td>Passive / well off</td>
<td>Active / troubled</td>
</tr>
<tr>
<td>Regulation</td>
<td>Relaxed / supportive</td>
<td>Intensive / restrictive</td>
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Themes for the years to come

Banks

- Higher capitalisation = Increased cost of capital
- Matched funding = Longer dated funding, or shorter lending, higher cost of raising liquidity
- Ability to access longer dated funding will be key
- Banks to compete for investor attention/capital

Corporates

- Availability of medium/long term bank financing to decrease over time
- Banks aggressive in providing shorter dated facilities
- Alternative funding sources increasingly important
- Pension reform and demographics positive for capital markets financing

Bank and capital markets will continue to represent complements to each other and the relative share of capital markets funding for Corporate borrowers will increase in relative terms
Themes for the years to come

**Debt structure**
- Debt structure to match asset profile
- Uneconomic to fund fixed assets in bank market for blue chip issuers

**Credit rating**
- Frequency of issuance to determine need for rating
- Mid-cap market for unrated borrowers to grow

**Internal preparations for accessing capital**
- Communication with investors and availability of information

**Buy-side more diverse and professional**
- Analytical competence, credit analysis
- Competition for pension and savings assets – opportunity to include new stakeholders

Capital markets will continue to expand in terms of tenors, eligible credits and size of corporate borrowers
Conclusion: significant potential effects on the banking landscape

<table>
<thead>
<tr>
<th>Systemic Effects</th>
<th>Idiosyncratic Effects</th>
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<tr>
<td><strong>Capital</strong></td>
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<tr>
<td>- Lower profitability in banking industry (measured as ROE)</td>
<td>- Higher capital costs may incentivise banks to move towards different business models (e.g. more fee based)</td>
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<tr>
<td>- Lower RoE may reduce investor appetite for banking sector capital raisings</td>
<td>- Balance sheet management techniques will develop</td>
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<tr>
<td>- Acquisition rationale and activity</td>
<td>- Substantial investment in IT infrastructure, reporting systems, and data management</td>
</tr>
<tr>
<td>- Greater stakeholder scrutiny regarding balance sheet usage</td>
<td>- increased expectations regarding stress testing capabilities and reporting</td>
</tr>
<tr>
<td>- Recalibration of RWA alters securitization market</td>
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<tr>
<td>- Increased counterparty credit risk capital requirements impact large derivatives and reverse repo players</td>
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<thead>
<tr>
<th><strong>Liquidity</strong></th>
<th><strong>Basel III Implications</strong></th>
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<tr>
<td>- Greater competition/increased costs for retail deposits</td>
<td>- Likely increase in cost of funding - the degree depending on balance sheet structure and funding strategy</td>
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<td>- Repo financing of securities positions will become more costly</td>
<td>- Implementation of legal entity ratio requirements will likely trap liquidity at banking subsidiaries</td>
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<tr>
<td>- Structure of wholesale funding markets is unclear given preferential treatment for more stable sources of funding</td>
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<tr>
<td>- Redesign of wholesale loan products, including committed credit and back-up liquidity lines</td>
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Source: PwC