

Seminar on Basel III

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Strengthening the resilience of the banking sector

Regulatory change- Basel Committee Proposals approved by G20

Increasing the quantity and quality of bank capital

Quality of bank capital

- * Tier1 will be largely equity and reserves

Quantity of capital

The overall ratios will rise and a leverage ratio to be introduced

- *Capital conservation
- *Countercyclical capital buffer
- *Forward looking provisions?

Capital requirements increasing

- * Trading book and securitisations

Counterparty risk

Changes to capital requirements

Changes to risk management

Global requirements for liquidity buffers

Liquidity coverage ratio – requires stock of high quality liquid assets

- *Stable funding ratio- illiquid assets have to be backed by stable funding

Timeline



Long transition provisions - final implementation 2023?

Higher risk weighted assets



Trading book requirements rising by a factor of 3+

A Trading book review is required locally

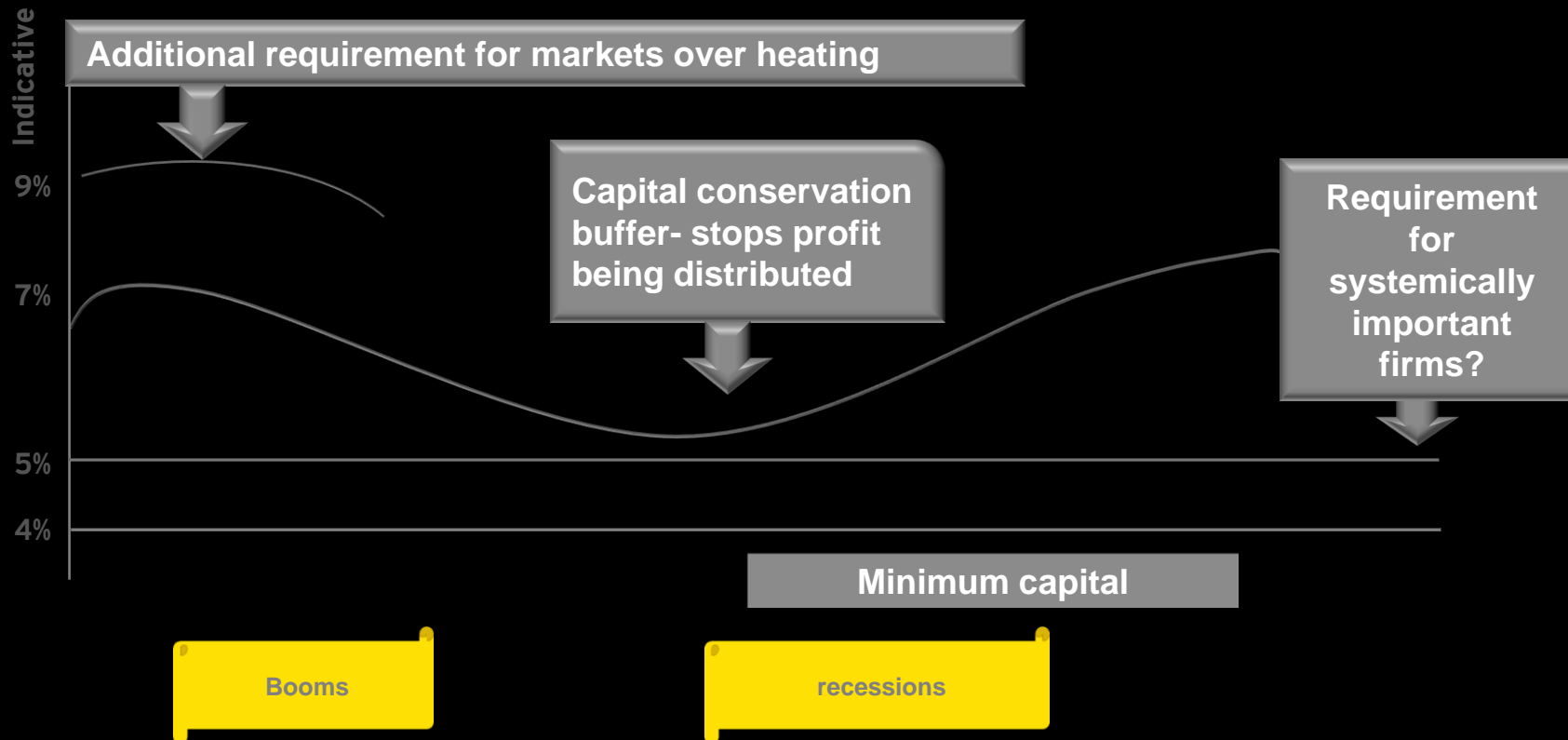
Increase coherence

Reduce opportunity for structural arbitrage

Capital Buffers

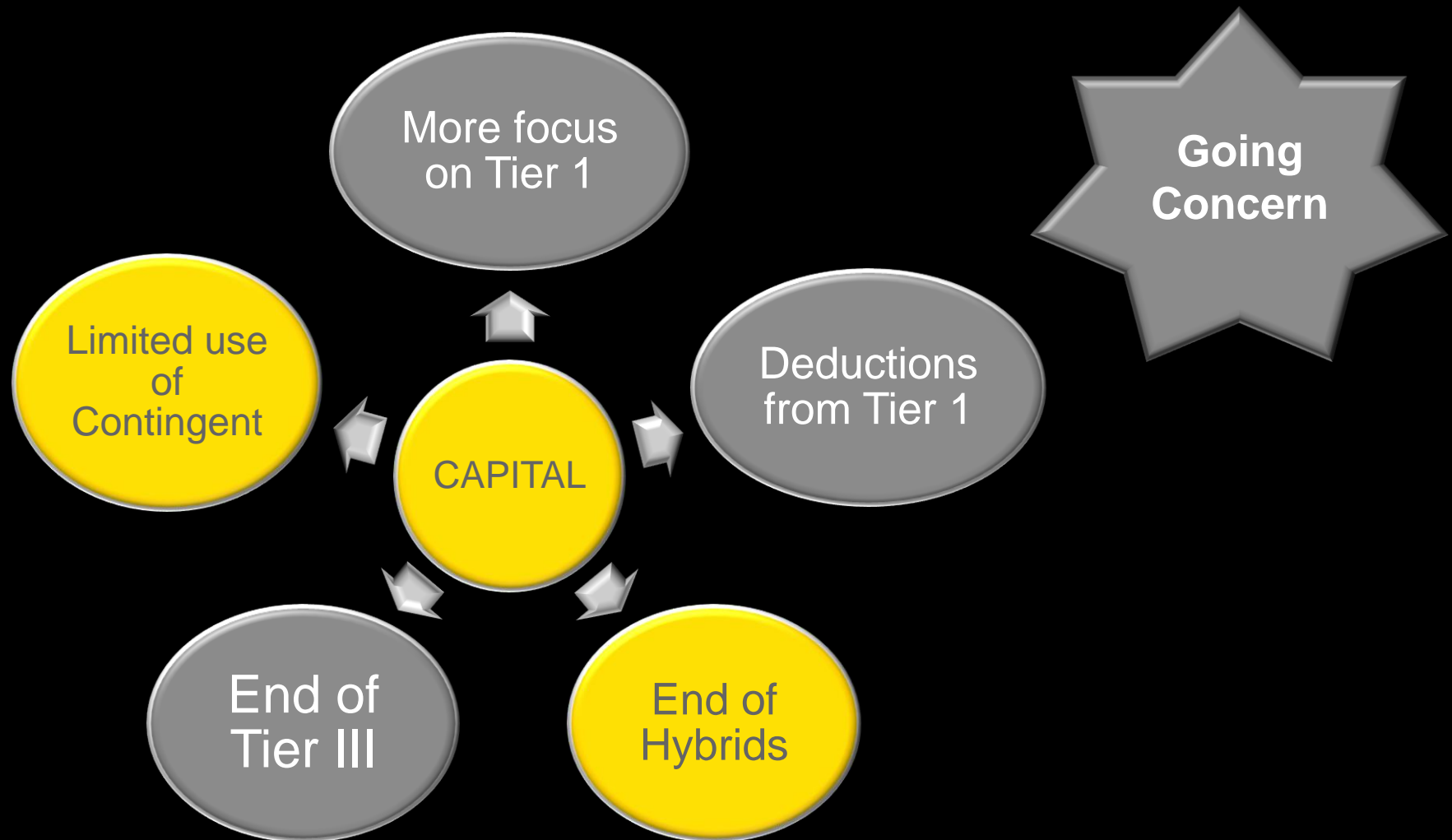
Basel III – focusing on changing quality and quantity of bank capital

- Hybrid capital increased confidence effects
- Subordinated debt – was debt
- Equity capital not high enough



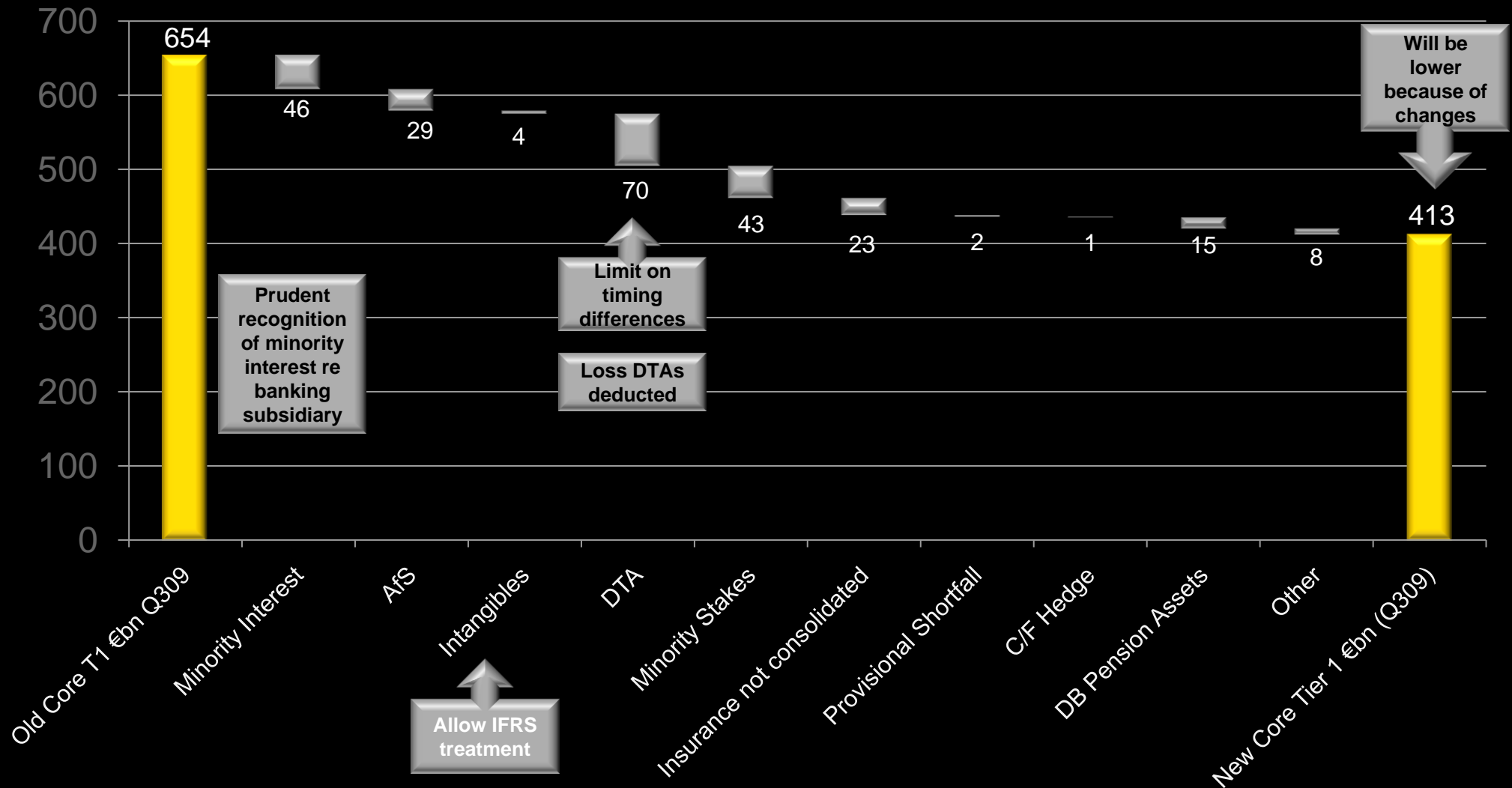
- But multiple buffers will add to complexity
- Too much capital will drive disintermediation
- Increase cost for industry

Definition of Capital – going concern gone concern distinction



- ▶ Much more capital required - possibly 10% Tier 1, then effect of deductions, higher requirements.

Deductions – the effect of the different proposals on European Banks' Core Tier 1 (€bn) – original vs current



Main industry concerns were minority interests and DTAs - minority interests somewhat relaxed

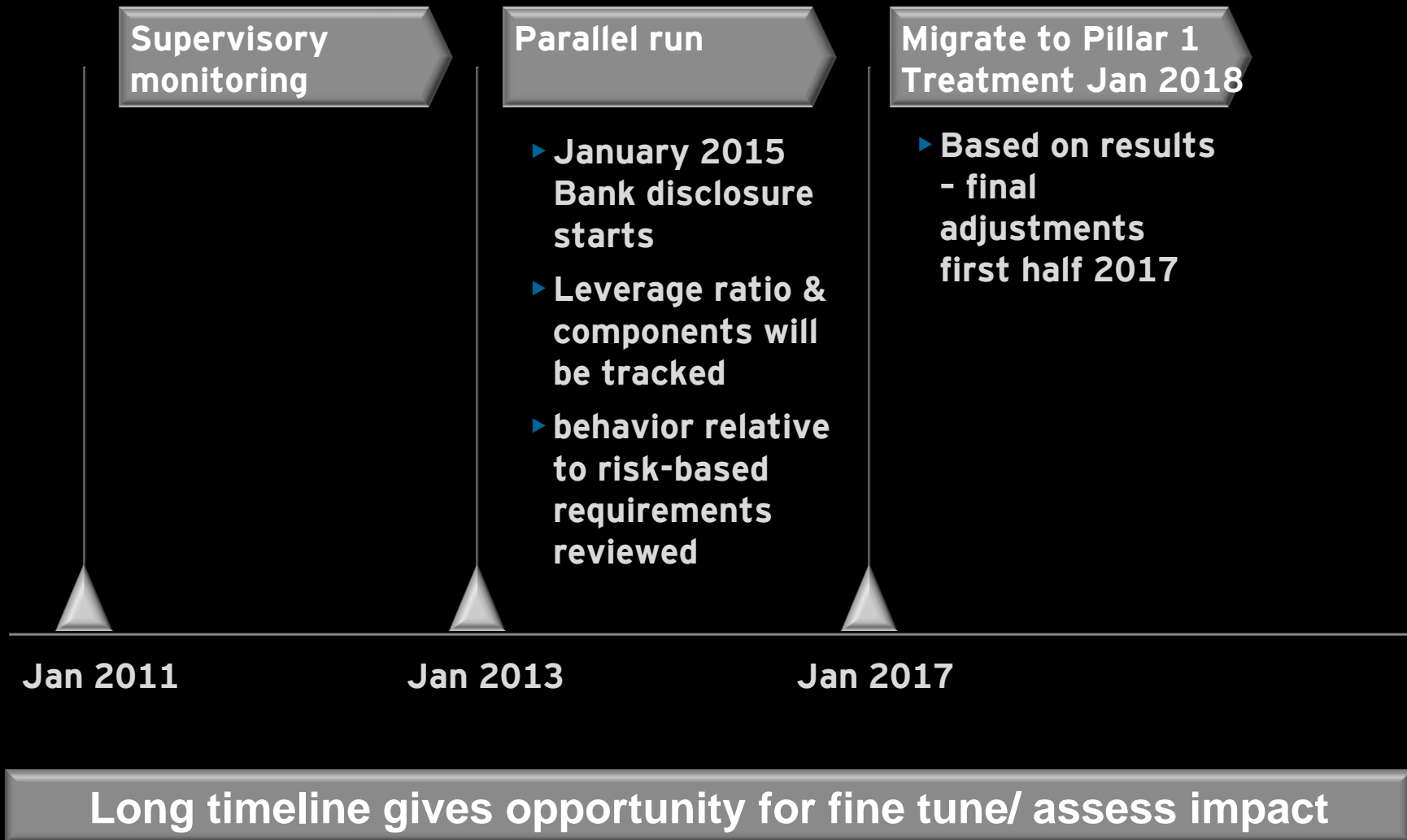
Source: Morgan Stanley Estimates

BCBS - Leverage Ratio

- ▶ The BCBS will introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework.

	Proposal	Optional Additions
Capital Measure		
Definition of Capital	Tier 1 capital – 3% during parallel run	Total regulatory capital/ tangible common equity
Total Exposure measure		
Exposure measurement	Exposure measure to follow accounting treatment - generally	
Off-BS items	Uniform CCFs 100%, cancellable OBS 10% CCF	
All derivatives including credit	Allow Basel III netting and standardised PFEs	

Timelines for the leverage ratio



Leverage ratio - Effects

- ▶ Much more restrictive than ratios in US, Switzerland and Canada
 - Inclusion of off-balance sheet items

QIS showed it was one of the most binding constraints. Now liberalised somewhat – netting and PFEs for derivatives

Potential distortions/ adverse incentives if leverage ratio is binding rather than risk-based capital

New Capital Instruments

Gone Concern

Instruments must absorb loss
Subordinated debt

Going Forward

All non-common equity
instruments and Tier 2 instruments ↓
Clause requiring them to be written
off on occurrence of trigger event eg
public sector injection ↓
Any compensation to instrument
holders paid in common stock

Going Concern

Proposal to allow contingent capital to
meet buffer requirements

Liquidity requirements

Liquidity Coverage Ratio (LCR)

- ▶ Banks should have sufficient high quality, unencumbered assets in order to meet stress scenario, specified by the supervisor
- ▶ Stock of high quality liquid assets > 100% (broadened to include more sovereigns & Level 2 assets 40% of stock – eg covered bonds, non-financial corporates)
- ▶ Net cash outflows over 30 days
 - ▶ Run off rate floors reduced - eg retail/SME-SME lowered to 5% (stable), 10% (less stable)

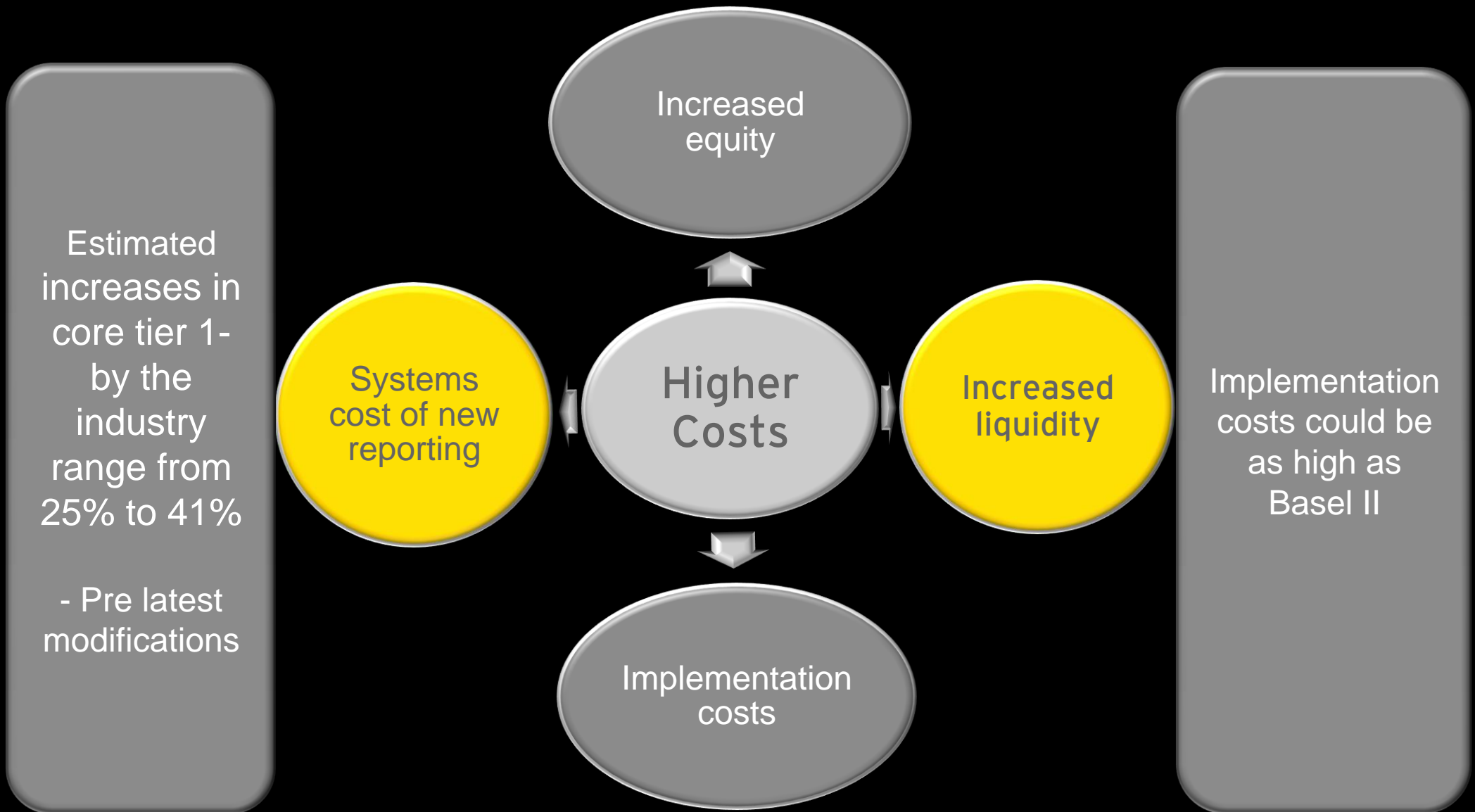
Net Stable Funding Ratio (NSFR)

- ▶ Intended to promote longer-term structural funding by requiring that the ratio of available stable funding to required stable funding exceeds 100% over a one year time horizon.
- ▶ Available amount of stable funding > 100%
 - ▶ Considering raising available stable funds factors for retail & SME
- ▶ Lower required stable funding for residential mortgages – 65% not 100%
 - ▶ Transition observation phase up to 1st January 2018

Reporting

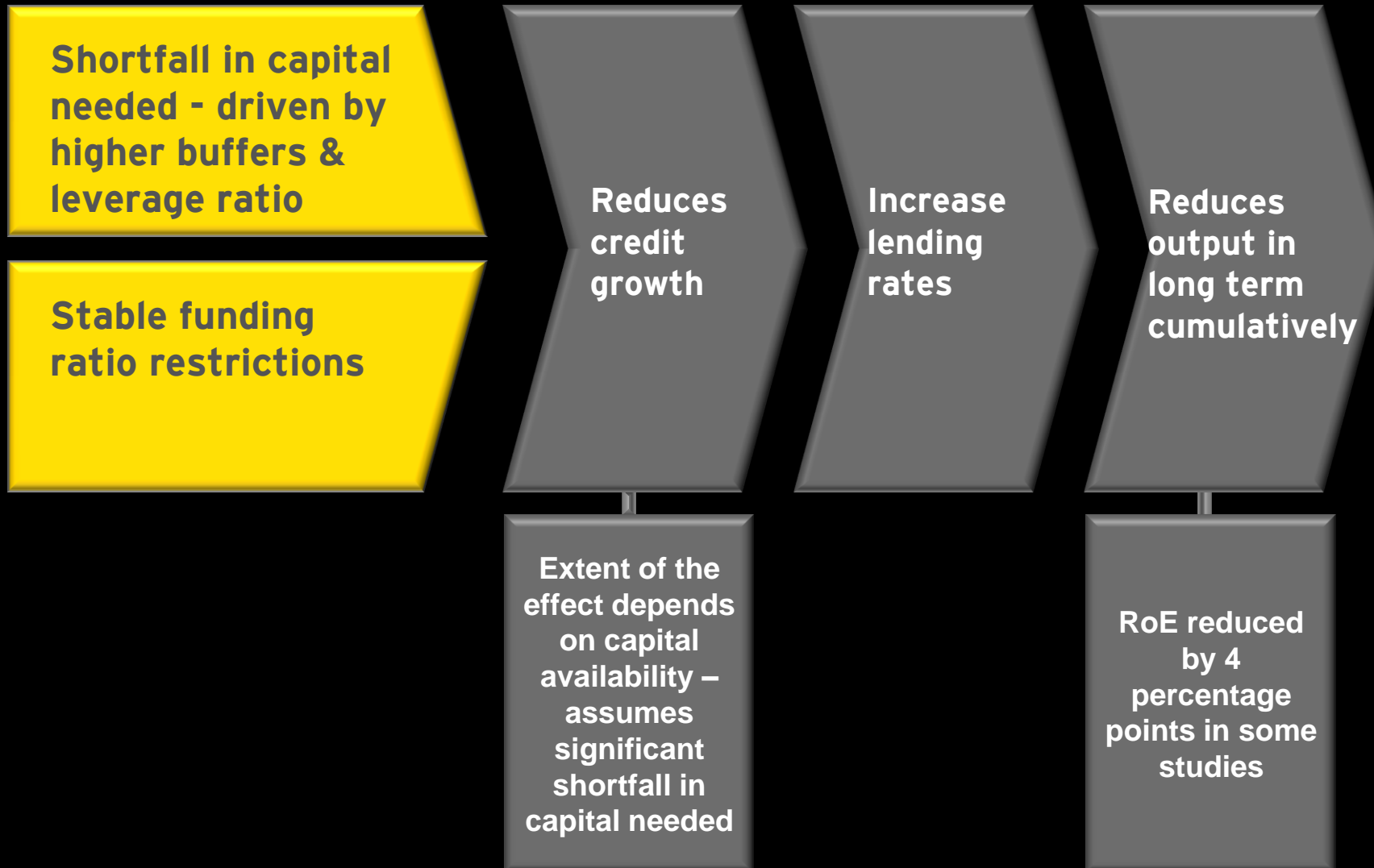
- ▶ **Contractual cash flow mismatch reporting (regulatory report)**
- ▶ **Concentration of funding (regulatory report)**
- ▶ **Available unencumbered assets (regulatory report)**
- ▶ **Market-related monitoring tools**

Implications



Industry impact analysis - Critics

Assumes all necessary capital may not be available



Basel Committee cost/ benefit estimates

- assume capital needed is available & high cost of crisis

Benefits

Reduced frequency/ severity of banking crisis

Crises per country
once in every 20/25
years

Each 1 percentage pt
↓ p.a. probability of
crisis

↑ Output by 0.6% pa

Effect of move 7% to
8% Tier 1 on likelihood
of crisis 3x larger than
move from 10% to 11%

Costs

Effect on spread → effect on output

Each 1 percentage pt ↑
In capital ratio
↑ spreads 13 basis pts

Liquidity
Standard – ↑
Spread 25 basis pts

Liquidity effect
reduced to 14 basis pts
on spread after
adjusting results for
low risk asset holdings

Assumes 15% ROE

Spread ↑ 7 basis pts with 10% ROE

Net
benefits
of capital
&
liquidity
change
up to
capital
ratio of
15% or
16%

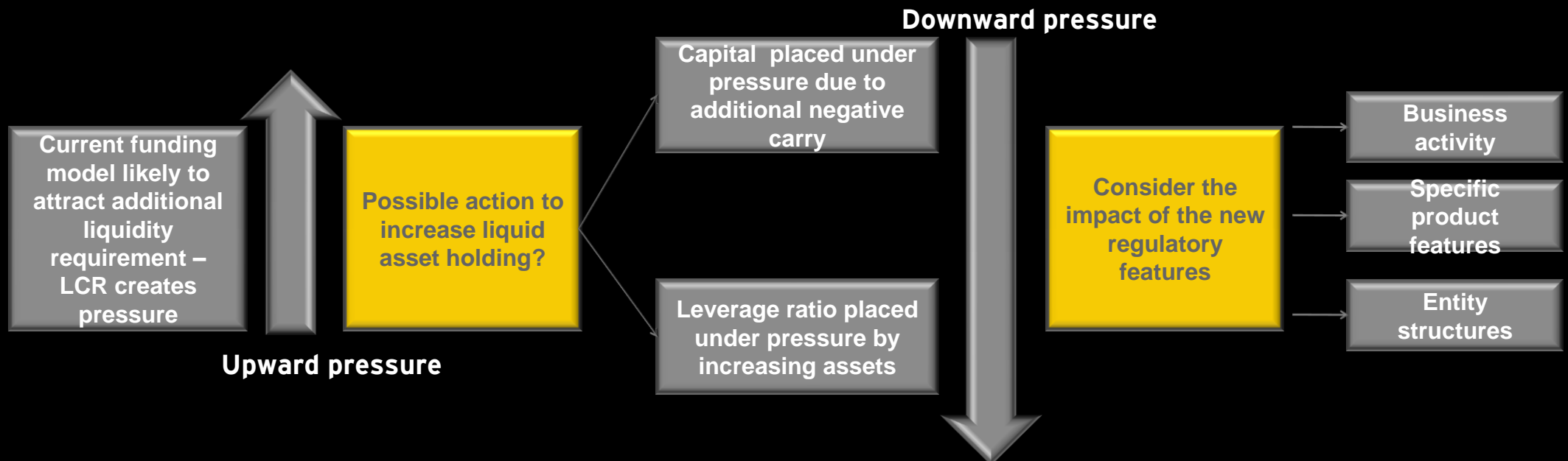
Implications for firms

- ▶ Fee and non-exposure based activities could be more popular- fund management
- ▶ Strategic planning needed- which businesses to expand, which to reduce, which to exit
- ▶ Lesser focus is on areas of massive capital increase- e.g. Trading/ Derivatives
- ▶ Overall increase in capital required for trading books will make activities less profitable

Overall effect could be greater disintermediation

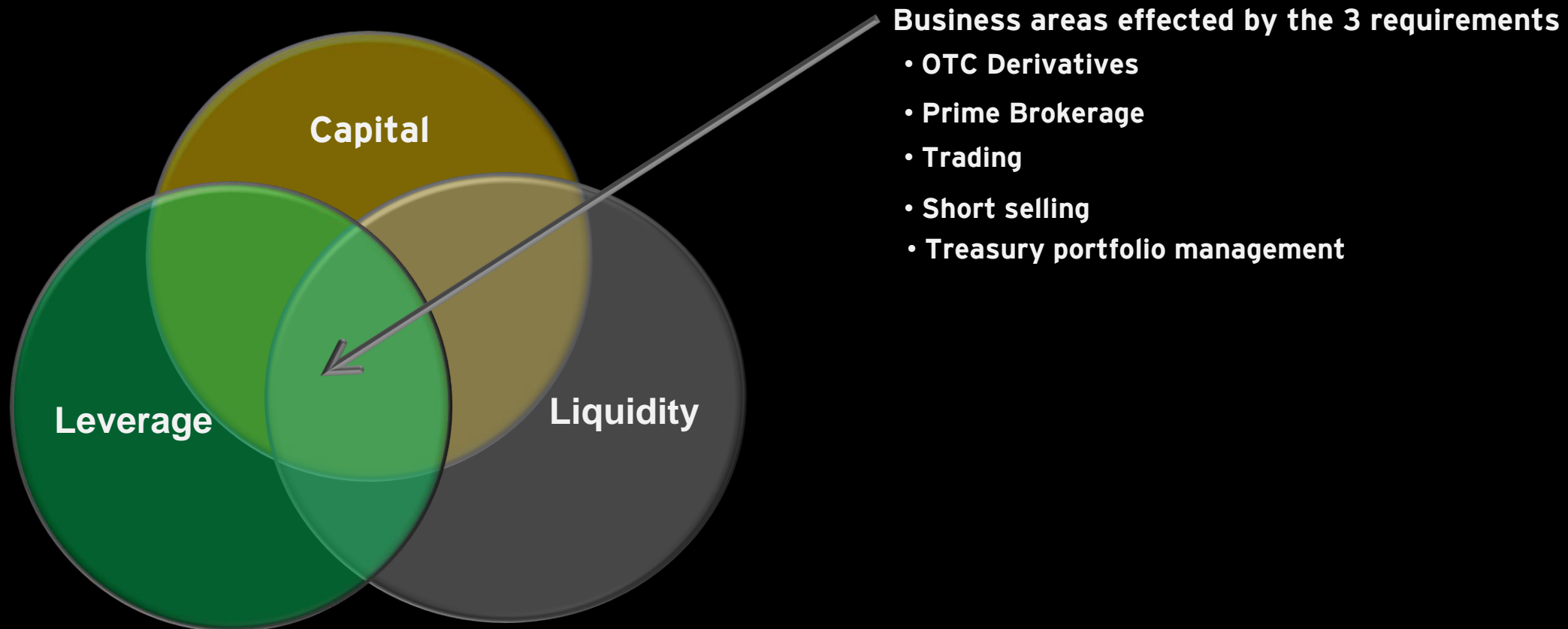
Strategic implications

- ▶ The proposed Basel III framework will impact and constrain business models across all aspects of balance sheet and off balance sheet use.
- ▶ Strategic planning and review is needed across products and business platforms including some entity structures – a number of fundamental factors are changing and the rationale for current practices may no longer be relevant.
- ▶ Current focus is on areas of substantial capital increase, but the impact of new liquidity and leverage constraints are often interrelated and conflicting in nature.



Business impacts

- ▶ Certain market related businesses will be less profitable because of capital, leverage and liquidity requirements.



Entity Impacts

- ▶ Cost/ rational of diverse legal entities will come under pressure
 - ▶ Ring-fenced capital in subsidiaries may increase pressure.
 - ▶ Effect of deductions
 - ▶ Interaction with Pillar 2 requirements

Setting the strategy

Calculate the implications of the changes

- Look at all business units

Need to estimate effect of changes on capital required for BU

Need to calculate required liquidity buffer

- Consider cost

Project forward earnings and adjust for costs

- Capital and liquidity as well as opportunity costs if there are constraints

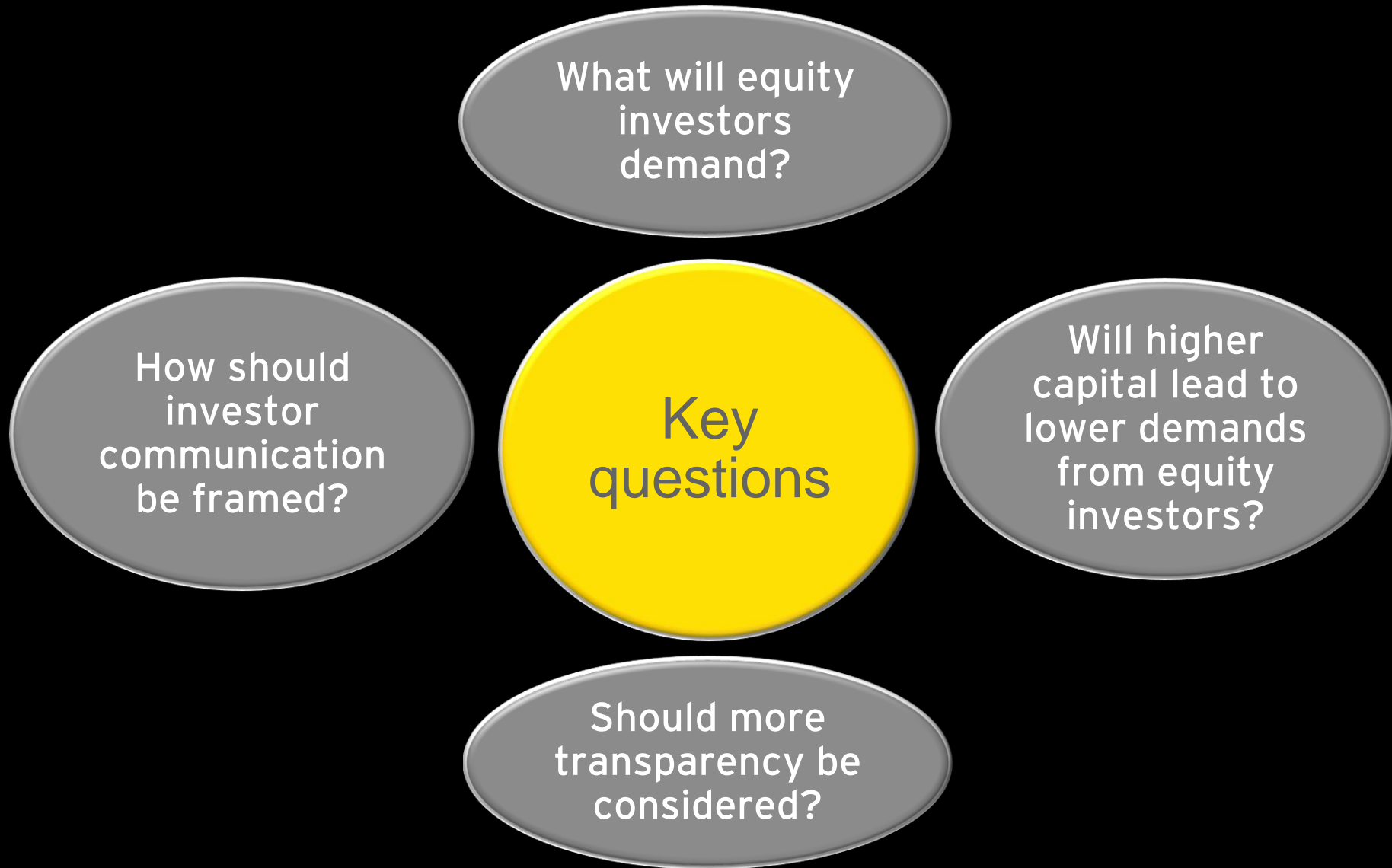
Consider which businesses to grow faster, which to grow slower, which to exit

Develop new funding model

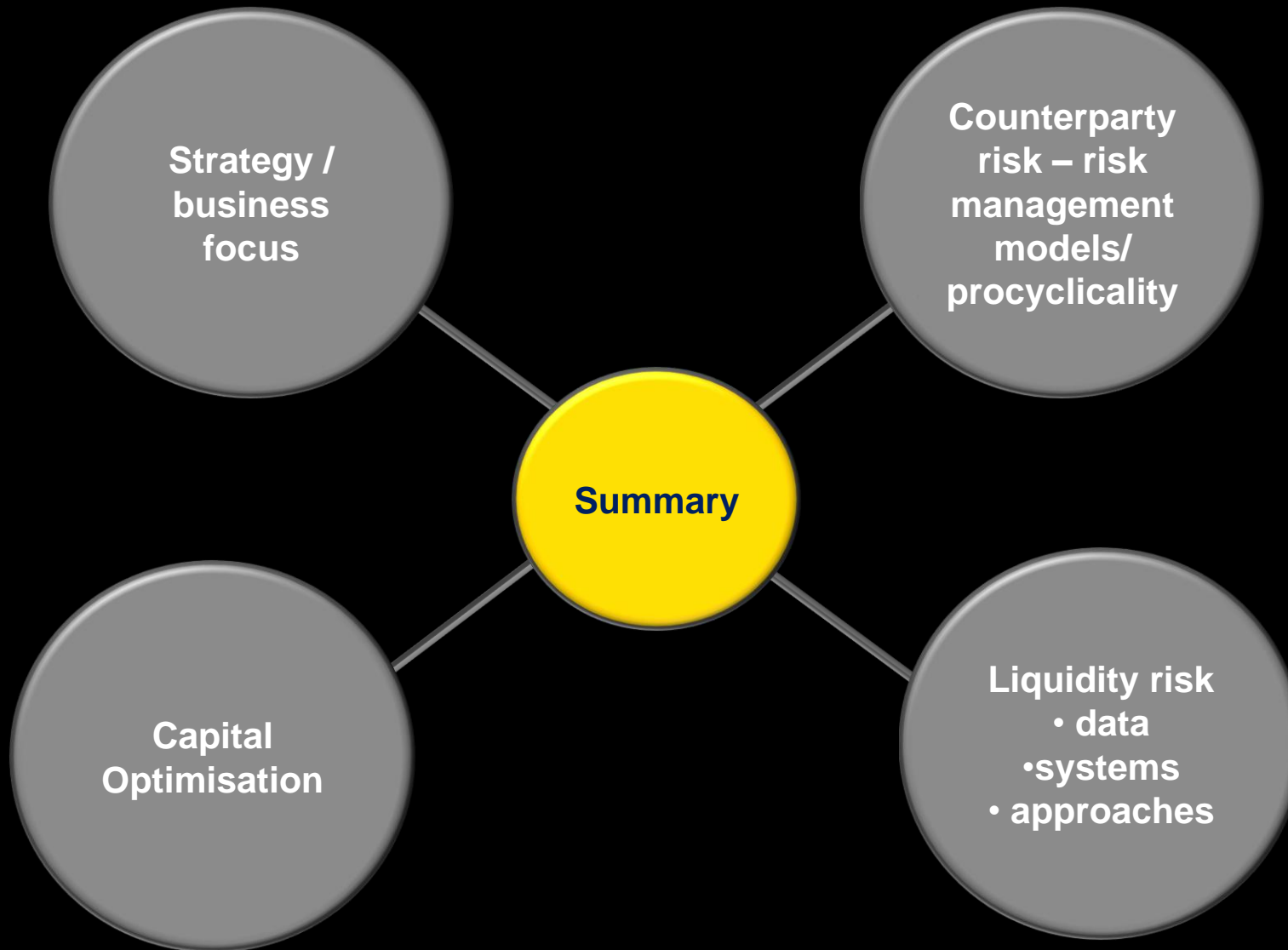
▶ New funding sources

- Look for longer term funding – more bond financing?
- Increased retail deposits
- More stable funding, longer term/ more locked in
- Consider pricing for funding – stable funding will be worth more
- Consider products which will lead to more stable funding

Rate of return on equity



Areas of focus



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