Executive Summary

In December 2010 and January 2011, the Basel Committee on Banking Supervision (BCBS) published wide ranging changes, in line with G20 decisions, to global standards on capital and liquidity requirements. While these standards are not binding, they are largely adhered to in the formulation of final rules in each jurisdiction. The aim of these standards is to promote a more resilient banking system, with an improved ability for banks to absorb shocks and a reduced level of systemic risk in the banking sector as a whole.

The Basel III package of standards are contained in the following three documents:

- Capital Adequacy – BCBS 189 - ‘Basel III: A global regulatory framework for more resilient banks and banking systems’ (December 2010)
- Annex to BCBS 189 – ‘Minimum requirements to ensure loss absorbency at the point of non-viability’ (January 2011)

In Europe, new legislation will be needed to introduce these standards as rules – this is referred to as the fourth Capital Requirements Directive (CRD 4) which will amend existing EU measures. The European Commission has yet to publish a proposal for CRD 4 (and at this stage it has no plans to consult further on the proposal), but it is expected that both a regulation and a directive will be brought forward with technical standards to be developed by the new European Banking Authority (EBA).

The Association for Financial Markets in Europe (AFME) supports the objective of strengthening the banking sector and introducing measures that will reduce systemic risk whilst maintaining the banks’ ability to serve their client’s financing needs. However our members have identified a number of important technical issues, particularly in relation to the liquidity standards which must be resolved before the regulators implement Basel III to prevent local interpretation leading to divergences in international application which would undermine the objective of a consistent global regime. In addition, we have a number of key concerns. These can be summarised as the need to:

- consider Basel III in the context of the wider emerging prudential framework – including the work on systemically important financial institutions (‘SIFIs’), crisis management and macro prudential considerations;
- address the uncertainty concerning the liquidity regime, significant components of banks’ regulatory capital structures, and the application of CVA market risk capital calculations;
- consider the potential disruption to the banking sector and broader economy that could ensue from proposals as they stand;

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1 BCBS189 was revised in June 2011 to reflect a change to a weighting applicable under the standardised approach to the calculation of CVA capital requirements.
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- communicate to all stakeholders the preliminary status of measures such as the Net Stable Funding Ratio (‘NSFR’); and
- ensure the Basel III monitoring/transition periods are used to both calibrate and modify the design of the leverage ratio, Liquidity Coverage Ratio (‘LCR’) and NSFR.

The Commission proposals must be designed so as to take into account developments at the Basel level as these issues are addressed: this will be relevant to the decision to be made about the extent to which a regulation can be used to implement the standards.

Overview of Basel III and CRD 4 and other policy developments

A. Basel III and CRD 4

Basel III – and CRD 4 – are based around five building blocks:

1) **Strengthening capital**: change the definition of capital to improve the quality, consistency and transparency of banks’ capital base

2) **Enhancing risk coverage**: strengthen the risk coverage of the framework with new standards for counterparty credit risk exposures arising from derivatives, repos and securities financing activities

3) **Leverage**: introduce a leverage ratio that serves as a backstop to risk-based capital measures and is intended to constrain the build up of excessive leverage in the banking system and provide an extra layer of protection against model risk and measurement error

4) **Limiting procyclicality**: improve measures to address procyclicality (i.e. the cyclical effects of risk based capital requirements) - in particular, the introduction of countercyclical buffers in addition to capital requirements that vary with the economic cycle

5) **Improving liquidity management**: introduce a new liquidity framework, which includes two minimum liquidity risk ratios – a 30-day LCR and a 1-year NSFR – and a set of common monitoring metrics and application standards.

AFME welcomes the development of Basel III regulatory standards and sees them as a platform towards realising consistent and rigorous new capital and liquidity regimes. However, AFME and its members are of the view that clarification is needed on numerous important technical questions before Basel III enters into local legislative processes where interpretation may lead to divergences in international application. In response to these concerns, our understanding is that – helpfully- the BCBS is now embarking on a FAQ exercise.

At the EU level, we are seeking further clarification as to the legal frameworks that will be used to implement Basel III (i.e. extent that the CRD 4 will be split between regulation vs directive and the extent of technical standards to be introduced by the new European Banking Authority).

AFME members have been tracking the progress of the BCBS’ work and have analysed, for clarity of content and process, the Basel III package against the issues we have been
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monitoring. The outcome of this analysis is an updated list of industry issues in relation to the Basel III package, provided in the linked Tables.

The remainder of this note highlights several issues associated with the key measures of the Basel III package that are most material to our members and therefore their clients – Section 2 – and offers our high-level remarks on the emerging prudential framework – Section 3 – in relation to the Basel III package. (The issues discussed in Section 3 are not presented strictly in terms of Basel III’s five building blocks so we can focus on the issues of greatest concern.)

B. Key Issues

The status of the issues AFME has been tracking and analysed vis-à-vis the Basel III package are itemised in the linked Tables 1 and 2 along with new issues that have arisen with the publication of the final Basel III package, with CRD 4 specific issues captured in Table 3. Clarification is required on a number of points relating to the definition of capital, counterparty credit risk, leverage ratio, countercyclical buffers, LCR and NSFR. We highlight below, in descending order, those issues of most concern.

In part, some of our concerns arise from our view that preliminary status of measures such as the NSFR is not well understood by all stakeholders. Other concerns relate to the implications of the Basel III monitoring/transition periods, and the need to utilise them to truly review and potentially recalibrate and/or modify the leverage ratio, LCR and NSFR.

Liquidity Coverage Ratio (‘LCR’) – aims to ensure banks maintain adequate levels of unencumbered high quality assets (numerator) against net outflows (denominator) over a 30 day stress period

Recognising the marketability of assets

A key concern for AFME is the potential economic impact of not recognising the marketability of assets such as equities or gold as part of the LCR’s liquidity buffer (LCR’s numerator) or their contribution to a firm’s liquidity as inflows. The current approach implies that for all assets outside the narrow liquidity buffer, as currently defined, it is not possible to generate any liquidity value within a 30 day time horizon, and that any associated financing requirements (e.g. equity repo) would have to be fully covered by liquidity buffer eligible assets. As currently designed, the LCR might drive the funding of such assets outside the banking sector and may reduce market liquidity in these asset classes.

Haircuts applied to outflows and inflows

A further concern for AFME is the assumptions underlying the factors being applied to outflows and inflows. We are unclear on how these factors have been determined and in particular we view the 100% drawdown factor to be applied to undrawn committed liquidity facilities to be unrealistic. Transitional regime

Given these concerns about impact and other questions relating to the computation of the LCR, AFME will be pressing both the BCBS and the EU to use the monitoring period to examine fully the impact of the current design of the LCR and to make adjustments as necessary.

Disclosure

The disclosure requirements for the LCR are currently unclear and we recommend that public mandated disclosure occurs only after full implementation in order to reduce the
risk of potentially misleading information being given to the market before the rules are finalised.

**Net Stable Funding Ratio (‘NSFR’) design and calibration** – aims to establish a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution’s assets and activities over one year

**Outstanding design issues**

NSFR is a new measure. It is important that the NSFR gives a fair representation of the funding requirements of a bank’s assets and funding provided by its liabilities, so we are concerned that a number of design issues we have raised remain unanswered.

**Preliminary status**

While AFME and its members understand that the transitional arrangements applying to the NSFR (final revisions to be implemented by mid-2016) are designed to allow the BCBS time to adjust the design of this measure, we are concerned that the preliminary status of this measure has not been clearly communicated to all stakeholders. This lack of clarity is fueling speculation about banks’ NSFR positions which is forcing them to look at changing their balance sheets far in advance of the envisaged implementation of this ratio. The result may be the possible curtailment of banking activities that are essential to real economy.

**Disclosure**

Like the LCR, the disclosure requirements for the NSFR are currently unclear and – for the same reasons – we recommend that mandated public disclosures occur after full implementation.

**Definition of capital** – sets the qualifying criteria for tier 1 (going concern) or tier 2 (gone concern) capital and includes regulatory adjustments in the calculation of capital and the treatment of minority interests

**Loss absorbency at the point of non-viability**

In addition to common equity Tier 1 capital, Basel III recognizes other instruments as capital and determines how such instruments – which could, in the future, include contingent instruments (i.e. CoCos) - will be recognized within the new standards. One proposal that continues to be discussed is that regulators should have the power, when a bank reaches the point of non-viability, to convert debt obligations into equity. The BCBS’ January 2011 Annex has applied this principle to regulatory capital that is not equity (i.e. non-common Tier 1 and Tier 2 instruments) however, clarity is needed on the two alternative scenarios BCBS seeks to describe in relation to the powers of the authorities (as outlined in BCBS’s January 2011 Annex).

**Components of capital and deductions**

Clarification is needed on the calculations in relation to minority interests, and investments in financial institutions and the associated limit structures.

**Grandfathering**

The Basel III package includes a number of important clarifications in regard to grandfathering arrangements agreed for regulatory capital instruments already issued. Although this clarification creates greater certainty for banks, we remain unclear of all the implications of the agreed arrangements and their interaction with grandfathering arrangements in the existing EU capital requirements directives.
**Leverage ratio (LR)** – seeks to limit tier 1 capital to no less than 3% of exposure (so any drop in the ratio below 3% means it has been breached)

**Pillar 1 vs Pillar 2**

The BCBS’ single measure of leverage risk is not risk based. It was to be introduced as a Pillar 2 measure within the Basel III framework but later transitioned to Pillar 1 as a binding minimum requirement. We support the transitional arrangements BCBS has put in place to assess the currently proposed design and calibration in reference to the full business cycle and different business models, but AFME is of the view that the LR should remain a Pillar 2 measure and should not be transitioned to Pillar 1.

A Pillar 2 approach to leverage risk will allow supervisors a greater opportunity to assess a bank's approach to measuring and managing its leverage risk. We therefore welcome indications that under CRD 4 there might be greater flexibility to the assessment of leverage risk with the Basel III LR forming only one possible measure of this risk.

**Disclosure**

Our members are also concerned that as currently drafted the Basel III package requires disclosure of the LR before the parallel run is complete (disclosure is to start on 1 Jan 2015 and the parallel run finishes on 1 Jan 2017). AFME and its members are concerned that any changes in a bank’s leverage ratio associated with changes in the design and/or calibration, or indeed changes in bank specificities, introduced over the parallel run, may not be well understood by the market and other stakeholders. In practice, disclosure may also have the effect of restricting the capacity to make any changes considered to be necessary given lessons learnt in the parallel run; this would clearly be undesirable.

**Credit Valuation Adjustment (CVA)** – seeks to take into account the deterioration of the credit worthiness of a counterparty in the context of bilateral derivative transactions. CVA is one of several changes to the capital adequacy and operational requirements for counterparty credit risk. Under Basel III firms can use one of two approaches to compute CVA risk: (i) a more risk sensitive advanced approach applying to banks with the relevant model approvals and (ii) a standardized approach applying to all other banks. The former uses expected exposure (EE), credit spread, and loss given default (LGD) parameters based on markets instruments (and requiring banks to have the requisite model approval) while the latter uses exposure at default (EAD) measures and external ratings.

There are a number of highly technical issues associated with both the advanced and standardized Basel III CVA capital methodologies. Concerns associated with the advanced approach include the lack of recognition given to hedges against non-credit related market risks and the definition of key parameters (such as market LGDs). Concerns associated with the standardized approach include its inappropriate calibration, its treatment of the maturity of netted sets and the inability of banks to use their own measures of probability of default (PD).

The inability to use own measures of PD is a particular concern to firms that do not trade their CVA risk owing to their business model or hedge CVA risk because for many corporate counterparties (particularly in the EU), there is no liquid market for such credit protection. These banks will be facing potentially punitive regulatory capital requirements compared to those using the advanced approach. These charges will, in turn, be passed on to their clients.
Trading book review

While standardized treatments of CVA are being discussed as part of the wider trading book review that is expected to be published by the end of 2011, we are seeking clarification on process for implementing any changes to the CVA charge as well as assessing the cumulative impact of the trading book review.

EMIR

In the EU there is a particular concern that the impact of the CVA charge will be more pronounced for Sovereigns, mid-size corporates and SMEs as they are not able to put up collateral to the same extent as larger firms (which works to reduce the capital banks have to hold against doing business with them). So the relief offered by the exemption (from the requirement to clear standard derivative transaction through central counterparties) available to firms (under certain threshold conditions) deemed not to present a systemic threat under the proposed European Market Infrastructure Regulation (EMIR) will be effectively cancelled out if a similar carve out is not available under CRD 4. The interaction between the CVA charge and the Sovereign CDS market also deserves careful analysis.

Countercyclical buffer – will introduce a capital buffer add-on when the provision of aggregate private sector credit in relation to GDP exceeds a long term trend

Operation of the buffer and interaction with other parts of the Basel framework

We comment in Section 3 below on the macroprudential initiatives, of which the countercyclical buffer is just one. We also have a number of pragmatic concerns relating to the operation of the countercyclical buffer (e.g. circumstances under which the buffer would be released) and the interaction between the buffer and other parts of the Basel III framework (including forward looking provisioning and the use of through the cycle and downturn parameters in credit and market risk models in Pillar 1).

C. Clarifying the emerging prudential framework: need for a holistic approach

This note has concentrated on the Basel III package but it is important to understand that it is only one component, albeit an important component, of the overall reform programme, being driven by the Financial Stability Board (FSB) and BCBS. As a consequence the overall framework has a number of moving parts and its cumulative impact is unclear.

There is thus a concern that the need for a holistic approach to the creation of an overall prudential framework, in which the initiatives being brought forward will dovetail, is not sufficiently understood by the regulatory community. The need to ensure that legislation reflects the new standards overall must be recognised as CRD 4 is taken forward.

Macroprudential initiatives and SIFIs

BCBS’s reform package includes initiatives relating to central clearing counterparties (‘CCPs’) and the development of a “macro prudential tool kit”. There are also a number of initiatives, aimed at the regulation and supervision of SIFIs, where BCBS (in coordination with the Financial Stability Board and other bodies) is reviewing the appropriate capital and liquidity treatment of systemic banks, including whether an additional SIFI capital and/or liquidity buffer is required.
**Crisis management and resolution**

There are also questions on how the work being done under crisis management will dovetail with the Basel III package and any SIFI surcharge, for example, whether the capital requirements for banks will recognise the extent to which they have effective recovery and resolution plans.

**Further information**

- Basel III implementation timeline (Annex 4/final page of BCBS 189)
- BIS Basel 3 consultations and press releases
  - Joint industry response to the Basel Committee's BCBS 164 and 165 ("December 2009 Package")
- AFME/ISDA response to the Basel Committee's BCBS 172
- AFME/ISDA response to the Basel Committee's BCBS 174
- FSB Intensity and effectiveness of SIFI supervision – Recommendations
- FSB Reducing the moral hazard posed by systemically important financial institutions

**EU Regulatory Capital page**

- Joint industry response to the Commission's CRD February 2010 proposal
- AFME/ISDA response to the EU Commission's CP on countercyclical buffers
- GFMA/ISDA First Wave of technical questions relating to the Basel standards III

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