Briefing note

Basel 3 and CRD 4

Executive summary

This note covers two pieces of reform:

- Basel 3 – Basel Committee’s December 2009 reforms aimed at strengthening the regulation, supervision and risk management of the banking sector (i.e. the core Basel 3 capital and liquidity reforms)
- CRD 4 – the European Commission’s consultation which considers how the Basel proposals could be applied in Europe.

While the core of these packages is clear the complete scope remains fluid. An overview is contained in the section below.

The reform, while broadly welcome, raises a number of issues outlined below:

- Outstanding detail of the proposals and calibration
- Implementation and transparency of the policy making process
- Convergence of supervisory approach
- SIFIs & G-SIFIs
- Key policy areas

This Briefing Note reflects the state of play as at the time of writing.

Overview of Basel 3 and CRD 4 and other policy developments

Basel 3 & CRD 4

The core of the Basel 3 and CRD 4 proposals aims to:

- improve the quality, consistency and transparency of the bank capital base;
- strengthen the risk coverage of the framework with new standards for counterparty credit risk exposures arising from derivatives, repos and securities;
- introduce a leverage ratio to contain the build up of excessive leverage in the banking system and provide an extra layer of protection against model risk and measurement error;
- improve measures to address procyclicality; and
- introduce a new liquidity framework, which includes two minimum liquidity risk ratios – 30-day liquidity coverage ratio (LCR) and a 1-year Net Stable Funding Ratio (NSFR) – along with a set of common monitoring metrics and application standards to allow supervisors to analyse liquidity risk trends at a bank and system wide level.

The European Parliament has expressed its own view on the direction the changes should take through Othmar Karas’ Own Initiative Report on CRD 4. In addition, the Basel Committee has provided updates on some aspects of the
package through the press releases of 26 July\textsuperscript{1} and 12 September\textsuperscript{2} 2010. These have provided clarity and detail on aspects the proposals (such as the level of the leverage ratio), as well as on the timing and sequencing of some elements (such as the liquidity framework).

The G20 recently endorsed the work that has been done by the Basel Committee to date on the core capital and liquidity standards – essentially formalising the proposed phased implementation timetable starting 1 January 2013 and completing 1 January 2019. It did not, however, provide further details on those areas where work continues on finalising policy.

We anticipate that the Basel Committee will finalise and publish the core standards around year end 2010. The Commission proposal is expected to be published in Q2 2011. There are likely to be some differences between Basel 3 and CRD 4 to take account of EU specific factors and the role of the new European Banking Authority (EBA).

The implications of the Committee’s capital proposals are likely to be very significant for the banking industry and the economy. Our concerns with capital proposals lie in: the detail of their design; where we believe there is significant overlap with other proposals (already in place or which the Committee and Commission are seeking to introduce); or where the interactions between the accounting and regulatory frameworks need to be considered.

\textit{Loss absorbency and countercyclical capital buffers}

Beyond the core elements of Basel 3 (outlined above) the Committee has also consulted upon proposals to ensure the loss absorbency of capital at the point of non-viability (thereby addressing the loss absorbency of gone concern capital). Furthermore the Commission and the Committee have consulted on proposals for countercyclical capital buffers. Further work is expected on going concern capital.

\textit{SIFIs & G-SIFIs}

The G20 confirmed their view that the moral hazard risks presented by SIFIs and the problem of ‘too-big-to-fail’ requires a multi-pronged approach that combines a resolution framework with more intensive supervisory oversight, robust core financial market infrastructure to reduce contagion risk and potentially supplementary prudential requirements. To address this issue the G20 has endorsed the Financial Stability Board’s (FSB) work programme (which is to involve the Basel Committee) on \textit{Reducing the moral hazard of systemically important financial institutions} (for key dates see Figure 1 below). At the centre of this programme is the principle that SIFIs, and in particular those that are globally systemic (G-SIFIs), should have higher loss absorbency capacity (than

\textsuperscript{1} BIS press release, “The Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package”, 26 July 2010
\textsuperscript{2} BIS press release, “Group of Governors and Heads of Supervision announces higher global minimum capital standards”, 12 September 2010
firms without this designation) to reflect the risk they pose to the global financial system.

It is unclear how the EU will take account of the work being undertaken by the FSB and Basel Committee. It is possible that elements of these proposals, which go beyond the core Basel 3 standards, will be included in CRD 4 or in further amendments to the CRD, or in other legislative proposals, such as those relating to crisis management.

**Basel 2.5 & CRD 3**

The Basel December Package and CRD4 were preceded by the Basel July 2009 Package / CRD 3 (and part of CRD 2), which introduced changes to the trading book (introducing high capital requirements to capture the credit risk of complex trading strategies) and strengthened the capital treatment for certain securitisations. These Basel reforms were published as *Revisions to the Basel II market risk framework – final version* and *Enhancement to the Basel II framework*. CRD 3 will be implemented by the end of 2011 (with provisions on remuneration coming into effect in January 2011). CRD 2 comes into force 31 December 2011.

**Key issues**

The key issues arising at this stage of the development of the proposals are as follows:

*Outstanding detail of the proposals and calibration*

There remain a significant number of outstanding questions regarding the detail of individual measures and on the application of the timing pronouncements. Given the materiality of the changes in train, the consequences of the development of the detailed measures, the timing of their introduction and their interactions with other parts of the framework, need to be fully understood to ensure that unintended consequences for the economy are addressed before finalisation. The significant differences in the assessment of impact highlight this issue.

*Implementation and transparency of the policy making process*

The timetable for implementation, while phased in some areas, is very tight. The overall lack of transparency in the policy development process, and the tightness of the timetable create the risk that sub-optimal policy choices will be made in relation to detailed measures and that firms, in preparing for implementation, will not have sufficient clarity over what is expected of them. A case in point is the introduction of monitoring and reporting from January 2011 for the leverage ratio and the liquidity framework.

*Convergence of supervisory approach*

Although all the G20 states have committed to implementing the Basel Accord fully, the Accord is not legally binding. The CRD, however, will have legal force
for EU banks and investment firms. This creates a risk of inconsistent implementation, causing regulatory and competitive distortions. It also brings challenges to international firms who may have to operate to inconsistent prudential requirements.

**SIFIs & G-SIFIs**

The core Basel 3 reforms seek to address the systemic risk through micro prudential measures. As described above, further reforms aimed at SIFIs are also being developed in parallel by the FSB with the Basel Committee. The detail of the proposals is not yet known but there are a number of associated risks:

- the designation of firms as systemic is difficult, as acknowledged by the Basel Committee; this will change over time and as circumstances change;
- there are potential moral hazards associated with such designation and it is not clear how this proposal fits with encouraging diversity in the system;
- additional requirements imposed upon these firms may unduly duplicate other regulatory measures and not make use of the full range of regulatory tools available.

**Key policy areas**

A key characteristic of the recent financial crisis was the inaccurate and ineffective management of liquidity risk, so we welcome the introduction of an international standard that promotes stronger liquidity buffers and strengthens the structure of funding. However, we are concerned that in their current form the proposals will result in a complicated set of calculations that overstate the liquidity risks being managed by firms.

Other policy areas that are of particular concern are the leverage ratio, the credit valuation adjustment, the buffers and SIFIs. Further comments on these policy areas are detailed below.

**AFME’s position**

AFME calls upon the regulators to be more transparent in their policy development.

**Outstanding detail and calibration**

In relation to the outstanding detail and policy position as we understand it regarding the key policy areas AFME seeks:

- further detail on grandfathering, treatment of minority interests and financial institutions within the definition of capital;
- a reconsideration of the methodology for the leverage ratio and its ultimate placement within Pillar 1 of the framework;
- alternative approaches to the computation of CVA risk that recognise different business models and hedging practices;
• continued dialogue about a number of aspects relating to LCR, including the asymmetrical treatment of intra-group facilities, the treatment of liquidity lines, the operational requirements directed at the control and use of the stock of high quality assets (liquidity buffer/pool), the criteria determining the eligibility of level 2 assets in the liquidity pool and the definition of the pool.
• further consultation on the design and calibration of the NSFR and any unintended consequences;
• further clarification of the role of Pillar 2 under the new framework;
• a reconsideration of the disclosures that will be required both before final calibration is settled and once the standards are implemented. If firms are required to publish the leverage ratio – and possibly the LCR and NSFR – in advance of their final calibration the market is likely to force firms to meet the new ‘standard(s)’ before the official implementation date and make any calibration adjustments difficult. Furthermore, once the standards are implemented, the proposed disclosure of the ratios, and in particular the liquidity ratios and monitoring metrics, could compound instability in times of stress; and
• an assessment of the reporting and infrastructure implications of monitoring and adjusting the various Basel 3 measures over their phased implementation.

Implementation and transparency of the policy making process

AFME believes the results of the Quantitative Impact Studies should be published, with details of proposed reviews to address consequences identified.

SIFIs & G-SIFIs

In regard to the framework being developed to address systemic risk, AFME believes it unnecessary – and likely to be counterproductive – to designate certain firms as being globally or nationally “systemically important” in order to impose on them further regulatory requirements and more intensive supervisory oversight.

However, given the G20’s decision to follow a path where some firms are designated as national SIFIs or G-SIFIs we recommend that the relevant bodies charged with bringing forward proposals in this area examine potential unintended outcomes of this policy, in particular, in terms of the impact on the wider economy, the increased risk of moral hazard, and the barriers to entry it might create. We also note that the G20 has given national regulators the capacity to require supplementary prudential and other requirements on SIFIs and urge individual regulators to commit to taking a proportionate approach.

Convergence

AFME seeks convergent implementation in relation to both substance and timing across the major financial jurisdictions.
## Figure 1: Key dates

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<th>2010</th>
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<td>Q4</td>
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### Capital / Liquidity / Loss Absorbency
- **End 2010: FSB / BCBS** – Macroeconomic impact assessment using Basel 3 framework (final report)
- **Mid-2011: FSB / BCBS** – Study on additional loss absorbency
- **March: EC** – CRD4 proposal expected
- **Mid-2011: FSB / Members** – Assessment of issues relating to contractual and statutory bail-ins
- **Dec: FSB / BCBS** – Recommendations on additional degree of loss absorbency and instruments

### Resolution
- **Mid-2011: FSB / Others** – Formulation of resolvability criteria and key attributes of effective resolution regimes
- **March: FSB Members** – Assessment of SIFI resolvability and needed legal and regulatory reforms
- **End 2011: FSB Members** – Assessment on the basis of resolvability criteria and key attributes of needed changes of national resolution regimes and policies
- **Dec: FSB / BCBS CBRG** – Thematic peer review on key attributes of effective resolution regimes
- **Mid-2011: FSB Working Group** – Recommendations on the legal / operational aspects of contractual and statutory bail-ins
- **End-2011: Home / Host G-SIFI authorities** – Institution-specific cross-border cooperation agreements for G-SIFIs
- **Mid-2011: FSB / National authorities / Others** – Determination of those institutions to which FSB G-SIFI recommendations will initially apply
- **Dec: FSB / BCBS CBCM** – Report on progress on institution-specific recovery and resolution plans for G-SIFIs

### Strengthening SIFI Supervision
- **Mid-2011: FSB Members** – Self-assessments against relevant ICPs on effective supervision
- **End-2011: FSB** – Status report on implementation of SIFI supervisory Intensity and Effectiveness Recommendations
- **Early-2012: FSB Members** – Self-assessments against relevant ICPs on effective supervision
- **Dec: FSB / BCBS / IAIS / IOSCO** – Report on improvements of supervisory colleges
- **Mid-2011: FSB / Others** – Formulation of resolvability criteria and key attributes of effective resolution regimes
- **End 2011: Home / Host G-SIFI authorities** – Institution-specific cross-border cooperation agreements for G-SIFIs
- **End-2011: FSB CBCM** – Report on progress on institution-specific recovery and resolution plans for G-SIFIs
- **Mid-2011: FSB Working Group** – Recommendations on the legal / operational aspects of contractual and statutory bail-ins
- **End-2011: Home / Host G-SIFI authorities** – Institution-specific cross-border cooperation agreements for G-SIFIs
- **Mid-2011: FSB / National authorities / Others** – Determination of those institutions to which FSB G-SIFI recommendations will initially apply
- **Dec: FSB / BCBS CBCM** – Report on progress on institution-specific recovery and resolution plans for G-SIFIs

### Strengthening Core Financial Market Infrastructures
- **Early 2011: CPSS / IOSCO** – Review of standards for financial market infrastructure (consultative report)
- **End 2011: CPSS / IOSCO** – Review of standards for financial market infrastructure (final report)
- **March: FSB OTC Derivatives WG** – Assessment of progress on implementation of FSB OTC Derivatives WG Recommendations

### Peer Review of G-SIFI Policies
- **Dec: BCBS** – Provisional methodology for assessing systemic importance (draft)
- **Early 2011: BCBS** – Provisional methodology for assessing systemic importance (finalised)
- **Mid-2011: FSB / National authorities / Others** – Determination of those institutions to which FSB G-SIFI recommendations will initially apply
- **End 2011: FSB / Standard setters** – Evaluation framework for G-SIFI policies
- **End 2011: FSB** – Establishment of Peer Review Council (PRC)
- **Dec: FSB PRC** – Initial assessment of G-SIFI policies

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### End 2010: FSB / BCBS – Macroeconomic impact assessment using Basel 3 framework (final report)

### Mid-2011: FSB / BCBS – Study on additional loss absorbency

### March: EC – CRD4 proposal expected

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### Dec: FSB PRC – Initial assessment of G-SIFI policies
Further information

BIS Basel 3 consultations and press releases:
http://www.bis.org/list/basel3/index.htm

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:
http://www.afme.eu/AFME/Policy_and_Advocacy/GFMAISDrespondetoBCBS172100910%20issued.pdf

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:
http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

Joint industry response to the Commission's CRD February 2010 proposal:

Public responses to the Commission's CRD February 2010 proposal:
http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/requirements_directive_1&vm=detailed&sb=Title

AFME/ISDA response to the Commission's consultation on countercyclical buffers:
http://www.afme.eu/AFME/Policy_and_Advocacy/AFMEISDACountercyclicalresponse251110Final.pdf

AFME’s Summary Position on the Basel Committee’s December 2009 Package and CRD4, September 2010:
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Published: 29 November 2010

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