Emerging from the chrysalis:

Reaction to the interim Basel announcement of July 2010
Introduction

The Group of Governors and Heads of Supervision – the oversight body for the Basel Committee on Banking Supervision (BCBS) – announced on 26 July 2010 that it had reached broad agreement on many of the key elements of the proposed capital and liquidity reform package originally announced in December 2009. This comes shortly after the release of a consultation paper on countercyclical capital buffers.

In this briefing we provide our initial thoughts on the announcement.

It is clear that the Committee has listened to the industry and a lot of progress has been made in a relatively short period of time to develop proposals that are prudent as the regulators require, yet allow banks to fulfil their economic functions.

Some important questions remain unanswered. More details are to follow after the quantitative and economic impact assessments are released, particularly regarding minimum target capital levels (core tier one, tier one and total capital ratio) and, following further consultation, countercyclical capital requirements (probably in September) and capital buffers (at the end of 2010).

Universal agreement was almost achieved amongst Committee members, but Germany has reserved its position and its concerns may need to be reflected in later amendments depending on the shape of the final package. We expect that all members will wish to form a view on the package as a whole.

Major themes to note are:

- The announcement confirms relief on capital and liquidity requirements from the original proposals, with scaled back rules including:
  - Less restrictive definition of capital and leverage ratio;
  - Less severe capital calculations for counterparty credit risk; and,
  - Less restrictive liquidity requirements.
- The Committee has extended the transition period for key elements. This reflects the difficulty in finalising such a complex package and the damaging effects on the economy of a rushed transition. For the leverage ratio and the net stable funding ratio (NSFR) the timetable moves from the end of 2012 to a transitional period with final implementation by 2018.
Our assessment

The equity markets have reacted positively, reading the announcement as a watering down that will benefit investors. However, we caution that only when the package is presented as a whole will the industry be able to assess the likely impact of what is being proposed. One needs to be careful not to jump to conclusions at this important but interim stage. And, of course, the devil will lie in the detail.

We are concerned in particular that the elements on which agreement has been reached will be presented to the G20 summit in November without finalisation on key elements such as capital buffers and NSFR. Another industry concern is whether calibration will allow banks to reward the providers of capital by earning an appropriate return in excess of the cost of equity.

Some big issues are worthy of debate:

- **Need for a top-down view**: the reform package process and the recent industry stress tests have created an intense focus on simple capital ratios. In our view supervision of banks is multidimensional: stability cannot be reduced to one ratio and Pillar 1 rules. This poses the risk of creating a tick-box compliance mentality rather than proactive risk management of the banks by management with appropriate oversight by supervisors. As the Committee recognises, effective supervision needs an holistic approach including micro- and macro-supervisory elements. With the focus on capital, liquidity and leverage ratios there is a risk that these aspects become de-emphasised. We believe that the overall reform package should address this risk. In particular:
  - Supervisors need a dashboard of indicators, not just simple ratios, and to have appropriate experience to interpret the results and to identify potential problems and discuss them with senior management of the banks. One option would be to strengthen Pillar 2 and perhaps more importantly the supervision processes, as well as tailored and targeted approaches for individual institutions to complement the new rules.
  - Management needs to have in place an appropriate approach to managing risks, building on their existing Basel II modelling and assessment disciplines but taking account of new market realities.

- **Coherent approach to capital deductions**: the revisions to the definitions remain a piecemeal set of adjustments. We feel that the Committee has an opportunity to put the various deductions on a more coherent footing for the future. In the December 2009 consultation paper, with its useful division between ‘going concern’ and ‘gone concern’ capital, there was an opportunity to address capital deductions from a more logical angle. In our view, items which have a value to a financial institution as long as it remains a going concern should not be deducted from core Tier 1 (i.e. going concern capital) as is currently proposed. For example, deferred tax assets arising from tax losses carried forward have a value to a going concern but do not have any immediate value in an insolvency. They should therefore be deducted from ‘gone concern’ capital. Similar principles could be set for the deduction of other types of assets (with more than one capital ratio being monitored).

- **Reconciling capital buffers and Pillar 2**: Although details are awaited, it appears as though the Committee maintains its ‘buffer-on-a-buffer-(on-a-buffer)’ approach. In our opinion, all the necessary buffers, whatever their rationale, should be covered by the capital stress testing carried out under Pillar 2, resulting in a single – institution specific – buffer that encapsulates all the factors and business model/mix of the institution and, particularly, supplements a series of pre-determined formulae with the judgment of experienced supervisors. Should specific concerns about the build-up of credit bubbles give rise to additional capital buffers, this could be handled in the form of specific guidance as to the scenarios to be included in capital stress testing, instead of a separate, standalone capital buffer. We appreciate that in some jurisdictions a simpler rules-based approach may be necessary, but we believe a more judgemental approach is central to strengthening micro-supervision and risk management in banks.

- **Focusing on funding**: the regime brings together three developments that impact the balance sheet structure of the banking system, and hence potentially impact the wider economy. These need to be considered as one package:
Impact on banks

There will undoubtedly (and rightly) be further changes, but enough is now known to make plans for the new regime. As the rest of this paper discusses, areas impacted are many and the consequences across a bank will be far-reaching – for example:

- Level of capital: hence impacts on return on equity and supply and pricing of credit and the long-term strategy of the bank (i.e. products and markets in which adequate returns can be made).
- Funding and balance sheet structure: lender and interbank relationships, product offerings.
- Capital requirements methods: systems, controls, data, IT.
- Capital and liquidity usage by business lines: business unit management, performance management, remuneration schemes.
- Holdings in financial institutions: future of holdings in insurance businesses.
- Minority interests: return on capital of part-owned subsidiaries.

Despite the remaining uncertainties, banks now need to get to grips with these proposals: they will impact strategy, returns and the businesses that banks choose to enter or exit.

Detailed proposals

a. Definition of capital

- Minority interests: The revised proposal allows the minimum capital required to support the subsidiary to count as group capital. This is a welcome move as the previous proposals would have had the unfortunate long-term effect of driving banks away from all but wholly-owned activities and thus (for example) would have reduced their ability to expand into new markets many of which do not permit wholly-owned activities. However, the proposal only seems to apply to holdings in banks (though this is not clear), so further clarity is required regarding minorities in non-banks.
  Investments in other financial institutions: Hedging and indemnity exemptions are now included so the investment to be deducted is more closely aligned to the actual “risk” position. This makes it easier for banks to manage their risk and get appropriate capital benefits.
- Allow IFRS treatment: The changes create welcome international harmonisation in determining intangibles and hence capital deductions.
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- For investments in unconsolidated financial institutions, mortgage servicing rights and deferred tax assets the banks have an allowance that is not a capital deduction (up to a maximum of 10% of common equity) before the full deduction kicks in (though the aggregate limit on the sum of these parts is 15%).

- Unconsolidated financial institutions (banks, insurance and other financial entities): This deduction is now restricted to holdings over 10%. This will be a significant benefit for banks with smaller holdings but for those with holdings over 10% the deduction is likely to remain a significant problem.

- Deferred Tax Assets: the new recognition of these (i.e. not a deduction from capital) is limited to timing differences. DTAs for losses carried forward are still proposed to be deducted from core tier 1. We believe that they would be better deducted from gone concern capital (i.e. total capital or tier 2), as they are valuable assets for going concern banks.

- Mortgage servicing rights. There may be scope for disputes over what is actually included in this category, and why mortgages get better treatment than, for example, intangible assets representing the value of investment management contracts.

b. Counterparty credit risk

The Committee has responded to industry concerns though modification of the bond equivalent approach (to allow hedging etc) and elimination of the 5x multiplier. The door is also potentially open to alternative approaches to the bond equivalent approach, but Basel only says that it ‘could be considered as part of the fundamental review of the trading book’, so as yet there is neither a timeline nor much certainty. The increased asset value correlation for financial institutions is maintained, but we believe it is still methodologically inconsistent with the Basel formulae and may have the unintended consequence of increasing capital requirements for products such as trade letters of credit, which are vital to the ‘real’ economy.

The proposal mentions ‘uniform’ credit conversion factors to be used for off-balance sheet items, however, it is not clear whether this means the use of a uniform 100% as originally proposed in December or the use of, for example, the Basel II standardised conversion factors.

The regime proposes an arbitrary risk weighting of exposures to central counterparties of 1-3%. This could have a significant effect on business settled through clearing houses. We agree with the need for a capital requirement on such balances, to avoid unrestrained expansion of such business at a bank level. However, calibration is a difficult challenge and we believe that a method linked to an assessment of the underlying risks may be more effective.

c. Leverage ratio

The new proposal replaces the original gross exposure approach to the leverage ratio with netting rules that are based on the standardised approach under Basel II. While beneficial for banks financially this is likely to create additional management information and data burdens for IRB banks. Similarly, the use of the current exposure method for the calculation of potential future exposure on derivatives increases the implementation and reporting burden for IMM banks.

The proposed 3% leverage ratio will cause the leverage ratio to bite on institutions with large secured lending books (for example mortgages or repos). The one-size-fits all approach is unlikely to work well, so the parallel running period will be important for future assessment.

There is a risk that disclosure of leverage ratios from 1 January 2015 may create uninformed market pressure on some participants. There are implications for external communication and investor education. Some banks may also decide to disclose earlier.
d. Regulatory buffers

As mentioned above, no new information is provided. Understandably BCBS is trying to get the baseline set before looking at buffers.

- **Forward-looking provisioning.** The IASB and FASB are under pressure from the European Commission to deliver conclusions by the end of 2011, but this is viewed as an ambitious timeline by some observers. Therefore a key element of potential procyclicality will come into play after finalisation of the Basel reform package. There could be significant operational issues with the implementation of these changes when they have been finalised.

- **Systemic banks, contingent capital and capital surcharge.** No useful additional detail is available yet. There is no date given for the proposed consultation paper on the topic, but the Committee will receive a progress report (and hopefully issue it) in September 2010. The systemic surcharge is moving to “guided discretion” which implies a Pillar 2 style item and that it may no longer be a Pillar 1 add-on. It is interesting that there is no mention of resolution regimes. In our view this is a critical part of the new regime, possibly the most important in terms of systemic risk, and we believe that this should receive more attention.

e. Liquidity

There is a welcome move to a wider definition of eligible liquid assets through the introduction of “Level 2” assets which can account for up to 40% of the total pool. Development of standards for these is to be undertaken up to September 2010.

Reflecting the amount of work that the Committee has already undertaken on liquidity, there is some helpful recalibration of haircuts, but no change to the stress period of 30 days.

There is mention of management of the liquidity pool being available to the treasurer, with implications of:

- Greater focus on the liquidity pool as a separately managed block of assets;
- Greater focus on the responsibilities of individuals for managing those assets as a single pool;
- More detailed definition of “unencumbered”; and,
- Potentially a greater focus on group liquid assets as opposed to compartmentalisation by regulated entity.

f. NSFR

The NSFR is still on the agenda. The announcement provides some recalibration of measurement criteria. There is a welcome medium-term transition and long phase-in period to 1 January 2018, reflecting the difficulty of calibration and the possible economic effects.

g. Countercyclical capital buffers

The consultation paper on countercyclical capital buffers (i.e. the macro economic buffers intended to counter credit bubbles) issued on 16 July sets out some details in an area which was only mentioned as work in progress in the December 2009 consultation paper. The 26 July 2010 announcement merely mentions that the Committee has developed a proposal to ‘operationalise’ expected loss provisioning and has written to the IASB. Neither of these documents has been made public to date. There is no further news in the announcement about countercyclical minimum capital requirements.
The consultation paper on countercyclical capital buffers envisages that each country will determine whether credit markets are over-heating, and an add-on expressed as a percentage of RWA will be applied to all exposures in that country. This add-on is expected to be applied rarely, say every 10 to 20 years.

In our view, a key issue with the countercyclical buffer (as with other buffers such as the conservation buffer) is for there to be clearly stated guidance as to when the buffer may be used. Otherwise there is a great danger that buffers become permanent add-ons.

As mentioned earlier, for capital buffers, we advocate simplicity, transparency and, where appropriate, the use of Pillar 2 to allow supervisors and firms to take into account the characteristics of individual institutions, the contexts in which they operate and the risks that they run.

If you would like to discuss the implications of the proposed changes, please speak to your usual contact within PricewaterhouseCoopers or one of those listed.

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