Pro-cyclicality; counterparty credit risk and leverage ratio

Summary of issues (other than capital) discussed in the Basel Committee consultation document published in December 2009 “Strengthening the resilience of the banking sector” (known as “Basel III”). It is noted these proposals have subsequently largely been adopted for consultation in an EU Commission Services Staff Working Paper published on 26 February 2010 (known as “CRD 4”).

1 Pro-cyclicality

1.1 Background: pro-cyclical nature of the current regulatory capital (“Basel II”) framework

One of the main areas that regulators are agreed upon is that measures must be in place to combat the inherent pro-cyclicality of the Basel II rules which require banks to hold more capital in a downturn, and less in an upturn, thus exacerbating the economic cycle. There are two key ways in which pro-cyclicality can be addressed. The first is through measures to mitigate the pro-cyclicality in capital requirements by, for example, changing the probability of default measurements to through the cycle, rather than point in time data and adopting an expected loss approach to provisioning. The second is building an overt counter-cyclical tool into the framework and, while regulators are agreed on the need for such a tool, the proposals from various bodies as to how to achieve this are different.

Previously, the counter-cyclical tool which had gained most traction in the international arena was a capital buffer, above the minimum capital requirements, which a bank would build up during the good times and which it could then drawdown upon as losses were incurred during a downturn. The method of achieving this suggested by the FSA and the European Commission in its Staff Working Paper of July 2009 followed the system of dynamic provisioning currently used by the Spanish regulator. Under this system, during an economic upswing, banks are required to build up a capital buffer by requiring “provisions” higher than those recognised by standard “incurred loss” accounting. During a downturn, banks can meet losses from it’s accumulated buffer. The buffer appears as a reserve, but does not count towards the regulatory capital of the bank. However, following a consultation on these proposals and further work in this area, the recent EU Paper adopts the rather different approach to address procyclicality suggested by the Basel Committee (discussed below).

1.2 Basel measures to reduce pro-cyclicality

(a) Capital buffer: The Basel III proposal to counter procyclicality differs quite considerably from the dynamic provisioning approach. The proposal requires banks at all times, not just in the good times, to maintain a capital buffer, called the “capital conservation range”, above the minimum capital requirement. If a bank’s capital falls within this capital conservation range, the Basel Committee proposes that the bank should be restricted from making distributions of earnings, whether by way of share buy-backs, dividends, or controversially, discretionary bonuses to staff. By applying at all times, this method will probably lead to higher capital levels throughout the economic cycle. In addition, it is proposed that there would be an upward adjustment of the capital buffer range when there are signs that credit levels have grown to excessive levels. This aspect of the proposal, which focuses more on the anti-cyclical element, was also suggested in the CRD 4 proposals but
is at an early stage of development. Further detailed proposals are expected to be published on this aspect of the proposals by both the Base Committee and EU Commission later in 2010.

The FSA has made clear in a recent consultation paper that it uses the Pillar II supervisory review process to impose a capital buffer requirement on banks in order to ensure that a bank can meet its minimum requirement in a future severe downturn. It is unclear how the current Pillar II buffer will be affected by the new buffer rules proposed by the Basel Committee. However, given that UK banks are already subject to an individual Pillar 2 capital buffer, the imposition of an additional amount may not have the same detrimental impact as it will on those banks which have not been compelled to create a capital buffer by their regulators.

(b) Expected loss approach to provisioning: The second measure proposed by the Basel Committee is forward looking provisioning based on the expected loss approach. The Basel Committee considers that this measure should be led by the accounting setters, and it is currently the subject of a consultation by the IASB\(^1\) and FASB\(^2\), and not by regulators. (In CRD 4 the EU Commission makes it clear that further work on how to address through the cycle provisioning for expected credit losses needs to be done and to assist in determining the best approach asks the market to undertake a comparative assessment of three different methods: the expected cash flow method (currently being looked at by the accounting standard setters), the incurred loss method (under international accounting standard 39) and the internal ratings based approach for recognising accounting provisions under Basel II).

(c) Probability of default (PD) measurement: The third technical proposal to restrain pro-cyclical trends is for banks using the Internal Ratings Based approach to use PD inputs which are the highest average PD of each exposure class.

1.3 Impact

There are still many uncertainties around whether the capital conservation range capital buffer will become the policy tool of choice or whether the Basel Committee will move instead to the dynamic provisioning approach previously advocated by the EU and UK. Irrespective of whichever approach is adopted, ultimately banks will be subject to increased capital requirements. If the capital conservation range is adopted, the likelihood of dividend restrictions may constrain equity investment in the banking sector, while restrictions on bonuses may make it harder for banks with weaker capital ratios to attract and retain top employees.

2 Leverage ratio

2.1 Background: leverage in the financial system

One of the underlying features of the financial crisis was the build-up of both on and off balance sheet leverage in the financial system, in particular, through the use of structured credit and derivatives. As the crisis evolved, banks were forced to deleverage, which increased the existing downward pressure on prices, exacerbating the link between losses from a fire-sale of assets and the decline in capital. This lead to a call for an unweighted

\(^{1}\) International Accounting Standards Board

\(^{2}\) Financial Accounting Standards Board
leverage ratio as an additional measure to the current Basel II risk weighted assets measure, the aim of which is to contain the build-up of leverage and reduce the link between deleveraging and the detrimental impact on capital adequacy.

2.2 Leverage ratio

While the exact ratio is not specified, on the basis that the determination of the number will be driven by the outcome of the quantitative impact assessment being carried out in respect of all the Basel III proposals, the Basel Committee sets out various features of the ratio. These include that:

(a) the capital measure (the numerator) will either be Tier 1 capital or just the common equity element of Tier 1 capital;

(b) the denominator will comprise all on-balance sheet exposures and some off-balance sheet items (at a 100% credit conversion factor); and

(c) exposures should be calculated net of provisions, and valuation adjustments and collateral cannot be used to reduce the exposure amount.

In addition, the Basel Committee proposes that either: (i) accounting or regulatory netting will be disallowed completely for these purposes, thereby focusing completely on gross measures of exposures, or (ii) netting will be allowed on the basis of the current Basel II regulatory netting rules. Clearly if netting is not permitted, the total exposure amount of the ratio would significantly constrain banks who, it may be expected, will argue that, if netting is permitted for general regulatory purposes, it is inconsistent to prohibit it for the purposes of calculating of the leverage ratio.

2.3 Impact

The Basel Committee leverage ratio has come in for criticism on the basis that it is not risk sensitive and is highly restrictive, particularly in relation to the proposal to limit or exclude netting of exposures, however it was approved in principle by the G20 (Toronto, June 2010). In any event, the introduction of a leverage ratio in whatever form ultimately agreed may require further deleveraging by banks, impact their earnings and profitability, and require a reassessment of the viability of areas of business that require leverage (possibly resulting in disposals).

Refer to Schedule for impact of existing capital/regulatory changes on bank balance sheets.

3 Counterparty credit risk

3.1 Background

There seems to be international agreement that, as part of the process of incentivising use of central counterparty clearing for derivatives, non-cleared OTC derivatives should be subject to higher capital charges. The EU Commission paper and joint HMT/FSA paper on this topic, both published in the fourth quarter of 2009, emphasised this approach, though determined that the Basel Committee would be the best forum for determining the relevant charges.

3.2 Proposal

The Basel Committee proposals in this area are extremely complex and go beyond merely incentivising the use of CCP’s, but address additional concerns highlighted by the crisis
including that derivatives were susceptible to credit related events in addition to default risk and concentration risks. The proposals, which in some areas are analogous to the new CRD 3\(^3\) trading book proposals, include that the capital requirement for counterparty risk must: (i) be calculated using stressed inputs; (ii) include a charge which reflects the risk associated with a deterioration in the credit worthiness of a counterparty (i.e. the credit valuation adjustment risk); (iii) include a charge for specific wrong way risk (i.e. the risk that arises when an exposure to a counterparty is positively correlated with the probability of default of that counterparty due to the nature of transactions with that counterparty); and (iv) for banks using the IRB framework, be calculated by applying a multiplier of 1.25\% to the asset value correlation of exposures to regulated firms with assets of at least $25 billion and all non-regulated financial firms, to reflect the risks from inter-connectedness. There are numerous other requirements including tightening the treatment of margin requirements.

3.3 Impact

Various groups, including ISDA, are currently reviewing the proposals as there are a number of immediate issues for banks in relation to the detailed calculations. While banks accept that higher charges and a more comprehensive framework is inevitable, there is a concern to ensure that the proposals are appropriately risk sensitive rather than penal. Further lobbying is expected.

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\(^3\) “CRD 3” means the proposed EU Directive amending the Capital Requirements Directive to introduce higher capital charges for exposures held in the trading book, securitisations and resecuritisations.
### Schedule

**BANK DE-LEVERAGING: BALANCE SHEET OF A NOTIONAL UK BANK**

<table>
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<th>Assets</th>
<th>Liabilities</th>
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<td><strong>Asset run-off</strong></td>
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<td><strong>Capital</strong></td>
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**EU state aid undertakings:** EU banks which have taken state aid will be required to make disposals (eg. RBS £200b, Lloyds £180b by 2014).

**Regulatory change:** banks to hold more capital against assets. If no fresh capital is raised, a bank’s balance sheet will need to shrink. Liquidity rules will force banks forced to hold more liquid assets (eg. gilts). Direct regulation on size and shape of banks (eg. Obama, Vince Cable).

**Asset run-off:** assumes borrowers able to repay loans (often only possible if borrowers themselves are refinanced). Refinancing with banks will be difficult if the banking sector is deleveraging. Borrowers may compete with banks to raise funding from debt capital markets (see wholesale funding) or equity capital markets (as financial institutions themselves seek more capital).

**Asset disposal:** query what price purchasers will pay given scarcity of debt funding. Any loss suffered by the bank will hit profit and may eat up capital.

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**Bank of England schemes:** special liquidity scheme (£185b) to be unwound by 2012, credit guarantee scheme (£250b) being phased out and asset purchase scheme (£200b) on hold. Total of £750b equal to 75% of UK GDP.

**Wholesale funding:** significant portion is short term, securitisation markets not fully open, funding costs remain high, banks need to raise a lot just to stand still (UK banks £420-750b) - at a time when corporate borrowers face huge refinancing needs (see asset run-off).

**Customer deposits:** difficult to increase in low interest environment.

**Regulatory change:** regulatory capital changes will make capital expensive (ie. pure equity). Basel III to introduce leverage ratio.

**Losses/impairments:** capital may be eaten up if banks impair assets or take losses on asset disposals.

**Equity capital markets:** banks will be raising capital at same time as corporates (see asset run-off) and insurers (Solvency II).