BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

# Annex

## Main design elements[1]

### I. Definition of capital

The Committee retained most of the definition of capital proposals set out in the December 2009 consultative package. However, it concluded that certain deductions could have potentially adverse consequences for particular business models and provisioning practices, and may not appropriately take into account evidence of realisable valuations during periods of extreme stress. Therefore, the following amendments to the December 2009 proposal have been agreed.

#### *Minority interest*

The Committee will allow some prudent recognition of the minority interest supporting the risks of a subsidiary that is a bank. The excess capital above the minimum of a subsidiary that is a bank will be deducted in proportion to the minority interest share.[2]

#### *Investments in other financial institutions*

The December 2009 reform package required that unconsolidated investments in financial institutions be deducted when the holdings exceed certain thresholds.[3] These thresholds continue to apply. The December paper also stated that gross long positions may be deducted net of short positions only if the short positions involve no counterparty risk. The Committee agreed to eliminate this counterparty credit restriction on hedging of financial institution investments and to include an underwriting exemption.

#### *Allow IFRS treatment where different from national GAAP (eg software)*

A level playing field is established through an option to use IFRS in determining the level of intangible assets if national GAAP results in a wider range of assets (eg certain software assets) being classified as intangible.

1 One country still has concerns and has reserved its position until the decisions on calibration and phase-in arrangements are finalised in September.

2 Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.

3 The December 2009 proposal states that (i) if holdings of common stock in financial institutions exceed 10% of the common stock of these financial institutions then the full amount of this holding should be deducted; and (ii) if a bank's holdings of common stock in other financial institutions in aggregate exceed 10% of the bank's common equity then the amount above 10% should be deducted.

***Treatment of significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities); mortgage servicing rights, and deferred tax assets from timing differences***

Instead of a full deduction, the following items may each receive limited recognition when calculating the common equity component of Tier 1, with recognition capped at 10% of the bank's common equity component:

- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities). "Significant" means more than 10% of the issued share capital;
- Mortgage servicing rights (MSRs); and
- Deferred tax assets (DTAs) that arise from timing differences.

A bank must deduct the amount by which the aggregate of the three items above exceeds 15% of its common equity component of Tier 1 (calculated prior to the deduction of these items but after the deduction of all other deductions from the common equity component of Tier 1[4]). The items included in the 15% aggregate limit are subject to full disclosure.

## II. Counterparty credit risk

The Committee is making the following modification to the treatment of counterparty credit risk, including the bond equivalent approach to calculating the credit valuation adjustment (CVA):

- Modify the bond equivalent approach to address hedging, risk capture, effective maturity and double counting;
- To address the excessive calibration of the CVA, eliminate the 5x multiplier that was proposed in December 2009;
- Keep the asset value correlation adjustment at 25% to reflect the inherent higher risk of exposures to other financial entities and to help address the interconnectedness issue, but raise the threshold from $25 billion to $100 billion; and
- Banks' mark-to-market and collateral exposures to a central counterparty (CCP) should be subject to a modest risk weight, for example in the 1-3% range, so that banks remain cognisant that CCP exposures are not risk free.

More advanced alternatives to the bond equivalent approach could be considered as part of the fundamental review of the trading book.

[4] The other deductions from Common Equity Tier 1 are: goodwill and other intangibles (excluding MSRs), DTAs that arise from net loss carry-forwards, investments in own shares, other investments in financial institutions not subject to the threshold above (eg reciprocal cross holdings), shortfall of provision to expected losses, cash flow hedge reserve, cumulative changes in own credit risk and pension fund assets.

## III. Leverage ratio

### *A. Definition of the leverage ratio*

The objective is to develop a simple, transparent, non-risk based measure that is calibrated to act as a credible supplementary measure to the risk based requirements.

The Committee agreed on the following design and calibration for the leverage ratio, which would serve as the basis for testing during the parallel run period:

- For off-balance-sheet (OBS) items, use uniform credit conversion factors (CCFs), with a 10% CCF for unconditionally cancellable OBS commitments (subject to further review to ensure that the 10% CCF is appropriately conservative based on historical experience).
- For all derivatives (including credit derivatives), apply Basel II netting plus a simple measure of potential future exposure based on the standardised factors of the current exposure method. This ensures that all derivatives are converted in a consistent manner to a “loan equivalent” amount.
- The leverage ratio will be calculated as an average over the quarter.

Taken together, this approach would result in a strong treatment for OBS items. It would also strengthen the treatment of derivatives relative to the purely accounting based measure (and provide a simple way of addressing differences between IFRS and GAAP).

When it comes to the calibration, the Committee is proposing to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. The Committee will use the transition period to assess whether the proposed design and calibration is appropriate over a full credit cycle and for different types of business models. This assessment will include consideration of whether a wider definition of exposures and an offsetting adjustment in the calibration would better achieve the objectives of the ratio.

While there is a strong consensus to base the leverage ratio on the new definition of Tier 1 capital, the Committee also will track the impact of using total capital and tangible common equity.

### *B. Transition to the leverage ratio*

The Committee agreed to divide the transition period into the following milestones:

- The supervisory monitoring period commences 1 January 2011. The supervisory monitoring process will focus on developing templates to track in a consistent manner the underlying components of the agreed definition and the resulting ratio.
- The parallel run period commences 1 January 2013 and runs until 1 January 2017. During this period, the leverage ratio and its components will be tracked, including its behaviour relative to the risk based requirement. Bank level disclosure of the leverage ratio and its components will start 1 January 2015. The Committee will closely monitor disclosure of the ratio.

Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

## IV. Regulatory buffers, provisions, and cyclicality of the minimum

### *Regulatory buffers*

The Committee has issued for consultation a countercyclical buffer proposal, with comments due by 10 September 2010. A fleshed out version of the conservation buffer proposal was already issued as part of the December 2009 consultative package and remains unchanged. The two proposals will be finalised jointly by the end of this year.

The *capital conservation buffer* should be available to absorb banking sector losses conditional on a plausibly severe stressed financial and economic environment. The *countercyclical buffer* would extend the capital conservation range during periods of excess credit growth, or other indicators deemed appropriate by supervisors for their national contexts. Both buffers could be run down to absorb losses during a period of stress.

### *Mitigating cyclicality of the minimum*

The December 2009 proposal included possible approaches to address any excess cyclicality of the minimum requirement. The Committee, through its quantitative impact study (QIS), has collected data to assess the impact of these approaches, the purpose of which is to adjust for the compression of probability of default (PD) estimates in the internal ratings based approach during benign credit conditions by using PD estimates for a bank's portfolios in downturn conditions. This work also will be informed by the findings of the Committee's Capital Monitoring Group on the cyclicality of the minimum requirement. The output would be a set of supervisory tools to assess the adequacy of banks' capital buffers in relation to the differing ratings methodologies used by banks.

### *Forward looking provisioning*

While capital focuses on unexpected losses, the Committee also has developed a concrete proposal to operationalise the expected loss approach to provisioning proposed by the IASB. The Committee sent a comment letter to the IASB on 30 June 2010 in which it spelled out its proposed approach. The Committee has been in close dialogue with the IASB on this topic.

## V. Systemic banks, contingent capital and a capital surcharge

In addition to the reforms to the trading book, securitisation, counterparty credit risk and exposures to other financials, the Group of Governors and Heads of Supervision agreed to include the following elements in its reform package to help address systemic risk:

- The Basel Committee has developed a proposal based on a requirement that the contractual terms of capital instruments will allow them at the option of the regulatory authority to be written-off or converted to common shares in the event that a bank is unable to support itself in the private market in the absence of such conversions. At its July meeting, the Committee agreed to issue for consultation such a "gone concern" proposal that requires capital to convert at the point of non-viability.

- It also reviewed an issues paper on the use of contingent capital for meeting a portion of the capital buffers. The Committee will review a fleshed-out proposal for the treatment of "going concern" contingent capital at its December 2010 meeting with a progress report in September 2010.
- Undertake further development of the "guided discretion" approach as one possible mechanism for integrating the capital surcharge into the Financial Stability Board's initiative for addressing systemically important financial institutions. Contingent capital could also play a role in meeting any systemic surcharge requirements.

## VI. Global liquidity standard

### *A. Liquidity coverage ratio (LCR)*

Governors and Heads of Supervision also agreed on the Basel Committee's concrete proposals to recalibrate the stress scenarios to achieve a conservative bank level and plausibly severe system wide shock. The Committee also made revisions to the definition of qualifying liquid assets subject to the overall requirement that such assets remain prudently liquid in periods of stress. The goal is to achieve a calibration and definition that penalises imprudent liquidity profiles, while minimising system level distortions. Specifically, Governors and Heads of Supervision endorsed the Committee's following revisions to the December proposal. The Committee will review the impact of these changes to ensure that they deliver a rigorous overall liquidity standard.

- *Retail and SME deposits*: Lower the run-off rate floors to 5% (stable) and 10% (less stable), respectively (from 7.5% and 15%). These numbers are floors and jurisdictions are expected to develop additional buckets with higher run-off rates as necessary.
- *Operational activities with financial institution counterparties*: Introduce a 25% outflow bucket for custody and clearing and settlement activities, as well as selected cash management activities. These activities will be clearly defined in the final rule and would require specific supervisory approval before the funds specifically related to those activities could be considered "operational" (ie not all funds from the counterparty would qualify). The bank that has deposited the operational deposits would receive a 0% inflow recognition for those deposits, as those funds would be expected to remain at the other bank during a time of stress. The Committee also is in the process of discussing the treatment of cooperative and savings bank networks and will provide a concrete proposal for consideration at the September 2010 BCBS meeting.
- *Deposits from domestic sovereigns, central banks, and public sector entities (PSEs)*:

For *unsecured funding*, treat all (both domestic and foreign) sovereigns, central banks and PSEs as corporates (ie with a 75% roll-off rate), rather than as financial institutions with a 100% roll-off rate.

For *secured funding* backed by assets that would not be included in the stock of liquid assets, assume a 25% roll-off of funding.

- *Secured funding*: Only recognise roll-over of transactions backed by liquidity buffer eligible assets.
- *Undrawn commitments*: Lower retail and SME credit lines from 10% to 5%. Treat sovereigns, central banks, and PSEs similar to non-financial corporates, with a 10% run-off for credit lines and a 100% run-off for liquidity lines.
- *Inflows*: Rather than leave it to bank discretion to determine the percentage of "planned" net inflows, establish a concrete harmonised treatment in the standard that reflects supervisory assumptions.
- *Definition of liquid assets*: All assets in the liquidity pool must be managed as part of that pool and are subject to operational requirements. The December 2009 proposal outlined that the assets must be available for the treasurer of the bank, unencumbered, and freely available to group entities. The Committee will finalise these operational requirements by the end of this year.

  As part of the narrow definition of liquid assets, allow the inclusion of domestic sovereign debt for non-0% risk weighted sovereigns, issued in foreign currency, to the extent that this currency matches the currency needs of the bank's operations in that jurisdiction.

- Introduce a "Level 2" of liquid assets with a cap that allows up to 40% of the stock to be made up of these assets.
  - Include (with a 15% haircut) government and PSE assets qualifying for the 20% risk weighting under Basel II's standardised approach for credit risk, as well as high quality non-financial corporate and covered bonds not issued by the bank itself (eg rated AA- and above), also with a 15% haircut.
  - Utilise both ratings and additional criteria as outlined in the December proposal (bid-ask spreads, price volatility, etc) to determine eligibility.
- Develop standards for review at the September 2010 BCBS meeting for jurisdictions which do not have sufficient Level 1 assets to meet the standard.

### *B. Net stable funding ratio (NSFR)*

The Committee remains committed to the introduction of the NSFR as a longer term structural complement to the LCR. Nevertheless, the initial NSFR calibration as set out in the December 2009 proposal needs to be modified. The main concerns related to the calibration of the standard and the relative incentives across certain business models, in particular retail versus wholesale. A number of adjustments are under consideration:

- *Retail and SME deposits*: Raise the Available Stable Funding (ASF) factor for stable and less stable retail and SME deposits from 85% and 70% to 90% and 80%, respectively.
- *Mortgages*: Lower the Required Stable Funding (RSF) factor to 65% (from 100%) for residential mortgages and other loans that would qualify for the 35% or better risk weight under Basel II's standardised approach for credit risk.
- *Commitments*: Lower the extent to which off-balance sheet commitments would need to be pre-funded, by lowering the previous requirement of 10% stable funding to 5% RSF.
- *Transition*: Carry out an "observation phase" to address any unintended consequences across business models or funding structures before finalising and introducing the revised NSFR as a minimum standard by 1 January 2018.

In addition to the potential changes listed above, the Committee will continue to consider whether to apply some amount of recognition to matched funding within the one-year time frame, as well as some other structural changes to the proposal.

The Committee will issue a set of proposals on the NSFR by the end of this year which will be subject to testing during the above mentioned observation period.