

Financial regulation of banks – liquidity and capital

A diverse range of reforms is being introduced to regulation of liquidity and capital in the banking sector. Some were planned pre-crisis, but far more radical reform is now emerging. The impact will be very significant for the sector as a whole and for individual institutions. It is too early to gauge the total impact, and whilst we have a “list” of the new measures agreed at G20 and under discussion at a European level, there is still a lot of work to be done on the development and calibration of each reform.

Financial regulation of UK banks results from a multi-layered policymaking process. International policy crystallises through the G20 and BCBS and is then translated into EC legislation, principally in the form of amendments to the CRD regime. Many of the internationally agreed rules are subject to read-across to investment firms via the CRD regime. The European rules are then transposed into domestic law – although in some cases, FSA has pre-empted reform measures and domestic rules already reflect – or exceed – international and European requirements.

This report breaks down the specific issues and policy responses, assessing the probable impact and detailing the timetable for implementation reforms impacting on banking liquidity and capital.

1) Stricter liquidity requirements

The issue: Ineffective liquidity standards were key to bank failures such as Northern Rock and problems in UK branches of Icelandic banks. There are concerns that some banks (Northern Rock was a prime example) rely too heavily on wholesale market funding and there are also broader concerns that firms (incorrectly) assume that assets can always be easily and immediately financed through the repo market and other such mechanisms – US investment banks financed as much as half of their entire on-balance sheet assets in this way. The crunch demonstrated the inter-relationship between firm liquidity, asset market liquidity and solvency.

At a systemic level, this involves central-bank-provided liquidity (normal and emergency). There are concerns that some smaller eligible banks and building societies have not even established access to and used/tested the BoE’s DWF.

The policy: Liquidity is now a focal point of policymaking at all levels. Liquidity regulation will be much tougher for deposit-takers, with a new emphasis on liquidity standards and liquidity insurance/contingent facilities/planning.

Individual Liquidity Adequacy Standards and Guidance

In the UK, FSA is pushing ahead with reform. On 5 October 2009, it published a new set of rules amending liquidity requirements under the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). Under these rules, in-scope firms will be subject to new Individual Liquidity Adequacy Standards (ILAS) (which will operate in a similar way to the ICAS regime for capital). They will have to carry out a liquidity adequacy assessment, which will be reviewed as part of SREP and subject to Individual Liquidity Guidance. FSA is also developing a new liquidity reporting regime, which will require firms falling within the scope of the regime to submit quantitative reports. The frequency and granularity of these reports will vary according to whether a firm is a standard ILAS firm (as will be the case of most banks and building societies) or a simplified ILAS firm.

Liquidity Coverage Ratio and Net Stable Funding Ratio

Work is underway at BCBS to develop internationally approved liquidity standards as part of its “Basel III” framework, which will apply to banks that carry on international activities. Following on from its 2008 *Principles for Sound Liquidity Risk Management and Supervision*, BCBS issued its consultative document *International framework for liquidity risk measurement, standards and monitoring* in December 2009 (accessible [here](#)). This proposed a Liquidity Coverage Ratio which, it has now been agreed, will require banks to hold stock of high-quality liquid assets sufficient to cover net cash outflows over a 30-day time period as a result of certain liquidity events (including public credit-rating downgrading, partial loss of deposits, loss of unsecured wholesale funding capacity, significant increases in secured funding haircuts, or increases in calls on derivative collateral or off-balance-sheet exposures). Additionally, a Net Stable Funding Ratio will require banks to maintain funding sources that are “stable”, by managing mismatches in funding profiles conservatively and avoiding reliance on shorter-term wholesale funding.

At a European level, the Liquidity Coverage Ratio and Net Stable Funding Ratio are due to be implemented through CRD 4.

The impact: The changes will mean banks have to hold much greater amounts of liquid assets. In a July 2010 [press release](#), the BCBS announced that the Basel III rules will recognise not only government bonds, but also high-quality, non-financial corporate and covered bonds not issued by the bank itself (e.g. rated AA- and above) as “liquid assets”. However, the BoE and FSA may nonetheless decide to apply their more restrictive definition, which only comprises gilts, central bank reserves and bonds issued by multilateral development banks. While FSA regulation is taking effect sooner than in other countries, it is not yet clear whether it will

be more demanding than international standards – this depends in large part on the quantitative elements requirements which the FSA has yet to determine and phase in.

The timetable: The implementation of the FSA’s new rules on liquidity is being carried out in a phased manner:

- The systems and control requirements took effect for all firms within their scope on 1 December 2009, although UK branches of overseas banks with a Global Liquidity Concession in place as at 30 November 2009 will not be required to conform to these requirements until 1 November 2010.
- As concerns quantitative requirements, FSA said it would not tighten quantitative standards before economic recovery is assured given that all firms were experiencing market-wide stress. An update in March 2010 confirmed that FSA believes it would be premature to increase liquidity requirements across the industry at the current time. This position will be reviewed again later on in the year with a further announcement in Q4, 2010. Firms will be able to apply for individual modifications of the rules which apply to them. Depending on the type of firm in question, the latest deadline for submission of applications for modifications was 15 December 2009, 1 March 2010 or 1 June 2010.
- Switch-on dates for firm-specific liquidity reporting requirements are 1 December 2009, 1 June 2010 and 1 November 2010.
- Although FSA’s new rules are designed to be flexible and their implementation is due to be phased, given that other jurisdictions are not yet requiring local firms to comply with similar liquidity frameworks, it remains to be seen whether FSA will cede to competitive pressures by deferring or waiving future rule phase-ins.

An observation period relating to the new Basel Liquidity Coverage Ratio will commence in 2011, and the ratio will be introduced on 1 January 2015. The revised Net Stable Funding Ratio will become a minimum standard by 1 January 2018. In the transitional period, the BCBS will monitor the ratios and review the implications of these standards.

Legislative proposals on CRD 4 are due to be adopted in December 2010, and political agreement on CRD 4 legislation may be reached by the end of 2011.

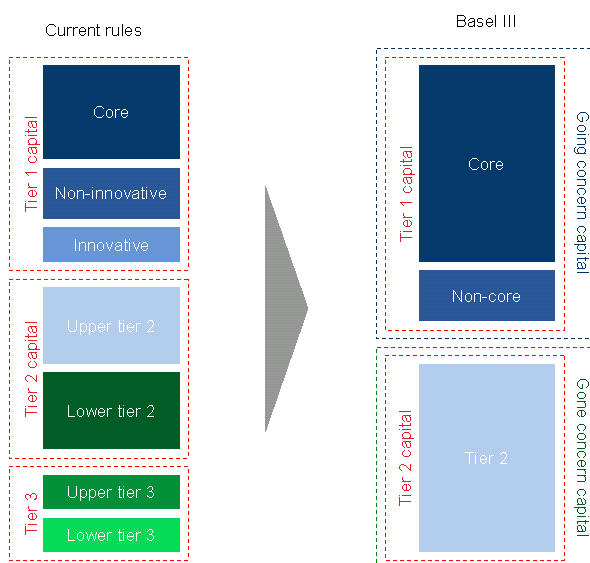
2) Improved capital, countercyclicality and a leverage ratio

The issue: The conclusion drawn from the recent crisis is that aggregate levels of capital in the banking system need to rise; during the crisis a number of banks faced the process of having to raise fresh capital to cover write-downs during an economic downturn. The quality of market capital is also a cause for concern; hybrid/subordinated debt used to meet capital requirements was not effective in absorbing losses during the recent economic downturn – there is a need for more common equity.

The BoE has been particularly critical about the existing Basel II regime and banks’ internal models, both of which – they contend – failed to constrain risky banking practices. Excess leverage was a key problem and banks internal models failed to take account of the real impact of a significant downturn. In December 2009, in parallel with its liquidity proposals, BCBS published a consultative document entitled *Strengthening the Resilience of the Banking Sector* (accessible [here](#)) outlining further measures to be included in the Basel III framework. These include significant changes to the quantity and quality of banking capital.

Fewer levels of capital

Under BCBS proposals, banks will be required to have two, rather than three levels of capital: Tier 1 “going concern” capital (capital allowing a bank to absorb losses incurred in the course of carrying on its activities) and Tier 2 “gone concern” capital (subordinated debt capital available in the event of the winding-up of the bank). Tier 1 capital should consist “predominantly” (meaning up to 85%) of common equity and retained earnings. These requirements will be supplemented with a disclosure and transparency regime to ensure that market participants are aware of all components of a bank’s capital.



Current Basel rules require banks to hold a minimum of 8% of total capital relative to risk-weighted assets (RVA), 4% of Tier 1 relative to RVA, and 2% of Core Tier 1 relative to RVA. Under Basel III, the total minimum capital requirement will remain at 8%, but the Core Tier 1 requirement will effectively be 7%, comprising minimum common equity of 4.5% plus 2.5% in the form of a capital conservation buffer (see “Countercyclical measures” below). It is likely that there will be a further add-on for systemically important financial institutions (SIFIs). The FSA, however, has already pushed ahead with stricter capital requirements and has informed banks that they must hold 8% of total capital relative to RVA, between 6% and 7% of Tier 1 capital relative to RVA, and must not fall below 4% in an economic peak-to-trough scenario.

Minority interests

One of the more controversial measures in the December 2009 BCBS proposals was the exclusion of minority interests (non-controlling stakes) from the common equity component of Tier 1, with a continued requirement to consolidate the RVAs of the subsidiaries. In its July 2010 [press release](#), the BCBS softened its approach, announcing that there will be some prudent recognition of minority interests supporting the risks of subsidiaries that are banks, and that the excess capital above the minimum of a subsidiary that is a bank will be deducted in proportion to the minority interest share.

Deferred tax assets

Under the initial reform proposals, deferred tax assets (i.e. past losses that can be used to offset future tax charges) and other “intangibles” such as mortgage servicing rights and investments in more than 10% of the common shares of an unconsolidated financial institution were also to be fully deducted from the common equity component of Tier 1. The BCBS has now confirmed, however, that any of these intangibles may be included in the common equity component of Tier 1, although recognition will be capped at 10% (or, in the event that several of these intangibles are aggregated, at 15%) of the bank’s common equity component.

Pension deficits

The BCBS has not, however, backed away from the proposed requirement for banks to deduct their entire pension deficit from their core Tier 1 (as opposed to the next five years’ contributions as is the case now).

Countercyclical measures

The framework proposed by the BCBS incorporates measures to reduce procyclicality, which require banks to build up capital defences and moderate excessive credit growth when economic and financial conditions are buoyant, so that the flow of credit in the economy is maintained when the broader financial system experiences stress. These measures include a countercyclical capital buffer above the minimum 4.5% core Tier 1 requirement (akin to the Economic Cycle Reserve proposed by Lord Turner), which will conserve capital by preventing banks from making distributions (e.g. in the form of dividends, return of capital or staff bonuses) when their capital falls within the buffer range. This capital conservation buffer will be calibrated at 2.5% and met with common equity, after the application of deductions. It will be adjusted in response to excessive credit growth, taking into account macro-economic parameters – details of its key elements and mode of operation are set out in a further consultative document published by the BCBS in July 2010 (accessible [here](#)). The countercyclical measures will also include a change in accounting standards (in line with IASB proposals) to allow forward-looking provisioning based on expected losses in place of the current “incurred losses” approach.

Counterparty credit risk

As part of its initiative to improve risk coverage, the BCBS has agreed on additional capital charges to account for counterparty credit risk, i.e. the risk that a counterparty defaults on a derivative contract prior to maturity. The new rules will include principles for the calculation of exposure on counterparty default and corresponding capital requirements. Exposure will be calculated on the basis of parameters calibrated over a three-year period, with one of these years being a stressed period.

Leverage ratio

The BCBS has further agreed that a leverage ratio will supplement risk-based capital requirements (following the model of countries such as Canada), and act as a backstop to avoid over-reliance on the constant evolution of banks’ internal models. According to the BCBS, the leverage ratio will be introduced as “a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration”. It will weigh capital requirements (as defined in the BCBS proposals outlined above) against total exposure. While exposure was initially due to be calculated in accordance with financial accounting principles, excluding physical or financial collateral, guarantees or credit risk mitigation, and without allowance for netting of derivatives, repo-style transactions, loans or deposits, the BCBS now intends to assess the impact of applying Basel II netting rules and a simple measure of potential future exposure based on the standardised factors of the current exposure method.

The EC intends to implement the Basel reforms regarding quality and quantity of capital, countercyclical buffers, forward-looking provisioning, counterparty credit risk, and a leverage ratio through CRD 4.

Contingent capital

While the December 2009 BCBS proposals did not address the issue of contingent capital, i.e. instruments with features of debt and equity, this issue was eventually addressed in a BCBS consultative document dated August 2010 (accessible [here](#)). The most recent proposals build on the concept of the “bail-in”, whereby subordinated debt can be written down or converted into equity at the initiative of the regulator, e.g. when there is a broader systemic need to bolster capital. They envisage that non-common Tier 1 instruments and Tier 2 instruments at internationally active banks must have a clause in their terms and conditions that requires them to be written off on the occurrence of either (1) a decision by the regulator to inject capital or equivalent support into the bank, without which the regulator considers the bank would become non-viable, or (2) a decision by the regulator that a write-off is

necessary in order to keep the bank viable. National authorities would be free to determine whether the holders of such instruments should receive compensation in the form of shares in the bank.

A number of other radical ideas for capital instruments with embedded insurance have been discussed within the industry, for example commitments to subscribe or hybrid instruments which convert to equity. The subscription or conversion could be triggered by circumstances relating to the issuer (so that the capital absorbs losses) – LBG was one of the first banks to implement this idea when offering ECNs (or CoCo bonds) with a trigger for equity conversion when its capital ratio fell below 5%. UniCredit is envisaging the issue of a bond that would allow for interest payments to be suspended and its value to be written down in the event that the bank's capital falls below pre-determined levels. It remains to be seen which of these concepts will be compatible with Basel III.

Contingent capital should be differentiated from hybrid capital instruments that feature incentives to redeem, e.g. through features like step-up clauses, as BCBS has indicated that these will be phased out. Although the current CRD regime does not yet contain provisions on hybrid capital instruments, FSA has thus far allowed the use of these instruments for Tier 1 (within the limit of 15% of Tier 1, as prescribed by the 1998 BCBS Sydney press release).

The impact: In the first half of 2010, BCBS carried out a quantitative assessment of the overall, cumulative impact of the proposed changes to the framework for firms' capital levels. The idea was to gauge the cumulative effects of various policy changes, such as the definition of eligible capital resources, strengthened risk-based capital requirements and supplementary measures (e.g. the leverage ratio) with a view to setting quantitative requirements accordingly.

It remains to be seen which measures will apply only to large banks, which will have broader application to deposit-takers and other BIPRU firms, and which will be calibrated according to firms' contribution to systemic risk.

The timetable: Full details of the phase-in and switch-on dates for the new Basel III capital rules are available [here](#). In summary, they are as follows:

- Phased implementation of the overall framework will start in January 2013. There will be a six-year transition period that will conclude at the end of 2018, and Basel III is due to be in full effect in January 2019.
- Basel member countries will be required to translate the new rules relating to the core Tier 1 requirement into national law by 1 January 2013. These rules will then be implemented in a phased manner between 1 January 2013 and 1 January 2015.
- The capital conservation buffer will be phased in from 1 January 2016 onwards, to become fully effective on 1 January 2019.
- Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over a 10-year period beginning 1 January 2013, whereas capital instruments that no longer qualify as common equity Tier 1 will be excluded from common equity Tier 1 as of 1 January 2013.
- Regulatory adjustments, including amounts above the aggregate 15% limit for investments in financial institutions, mortgage servicing rights, and deferred tax assets, will be phased in from 1 January 2014 onwards, and will need to be fully deducted from common equity by 1 January 2018.
- Existing public sector capital injections will be grandfathered until 1 January 2018.
- Supervisory monitoring for the BCBS leverage ratio commences 1 January 2011. The supervisory monitoring process will focus on developing templates to track the underlying components of the agreed definition and the resulting ratio. A parallel run period commences 1 January 2013 and runs until 1 January 2017, during which the BCBS is proposing to test a minimum Tier 1 leverage ratio of 3% and to assess its behaviour relative to risk-based requirements. Bank-level disclosure of the leverage ratio and its components will start 1 January 2015. Based on the results of the parallel run period, any final adjustments will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018.
- The BCBS consultation on loss-absorbent regulatory capital remains open until 1 October 2010. The Committee will issue a detailed report on its intended treatment of contingent capital in December 2010.

CRD 2 amendments bringing requirements on hybrid Tier 1 in line with the BCBS Sydney press release will apply from 31 December 2010, although these provisions may soon need to be reviewed again in light of the BCBS announcement that certain hybrid capital instruments will be phased out.

Legislative proposals on CRD 4 are due to be adopted in December 2010, and political agreement on CRD 4 legislation may be reached by the end of 2011.

Towards the end of October 2010, FSA is due to issue a new DP covering the overall economic impact of global reforms to capital.

3) Penalising the trading book

The issue: Excessive proprietary trading by deposit-taking banks is seen as a key cause of the crisis – described as using deposits to indulge in casino-style investment banking. This is a fundamental issue at both the macro- and micro-prudential level.

The policy: There will be significant reforms in this area. Already BCBS is introducing some immediate reforms to increase Pillar 1 market-risk capital requirements on the trading book. This involves standardised charges for securitised products, stressed

calibration of the capital requirements based on value-at-risk (VAR) and an incremental risk charge which will cover both default and migration risk.

BCBS is also undertaking a more fundamental review of the trading book regime. This might require a significant (as much as fivefold) increase in the amount of capital banks are required to hold against the trading book. However, other, more radical, tools are being considered (such as separation/legal barriers) and all of these tools will need to be looked at together. One question is how far reforms/tools/enhanced requirements will apply only to SIFIs – a BCBS sub-group is currently considering whether these firms should be subject to additional regulatory capital and liquidity requirements. For further details on the macro-prudential treatment of SIFIs, click [here](#).

The BCBS proposals are being implemented at a European level through CRD 3.

At a domestic level, the FSA has raised the prospect that firms may incur a “valuation uncertainty charge” which they would be required to apply to their capital in order to target valuations that capture risk poorly, as well as a capital charge for interest rate risks on amortised cost assets. It has also indicated that it will explore the possibility of linking capital requirements with market liquidity risk and with valuation.

The impact: Impact is difficult to gauge at this stage because it is not yet clear how radical and broad the reforms will be in relation to trading-book activities. However, the immediate changes will increase capital requirements held against the trading book to discourage reliance on models-based (VAR) measures of market risk.

The timetable: The immediate BCBS changes will be effective from the end of 2010. The broader review of trading book/market risk is due to be completed by end 2010, and a more comprehensive trading-book framework will become due for implementation by 31 December 2011.

The CRD 3 provisions relating to the trading book will take effect no later than 31 December 2011.

The FSA has invited discussion on its recommendations for a valuation uncertainty charge and related measures concerning firms' trading activities until 26 November 2010.

4) Further reforms

Further reforms affecting financial regulation of the banking sector are those relating to **accounting rules, stress-testing, securitisation and credit-rating agencies**. For an overview of these reforms, please click [here](#).

Banks are also likely to be affected by a number of **structural reforms**, outlined [here](#).

For an overview of the regulation of **remuneration** and the potential impact on bank capital, please click [here](#).