



Basel III: A Brief Overview

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- Basel III Final Rules Text (December, 2010)
 - > Overview and timing
 - > Key elements of the proposals and detailed capital criteria
 - > Regulatory adjustments/deductions and leverage
 - > Countercyclical capital buffer and capital conservation buffer
- Contingent capital requirements from Basel (January)
- OSFI Advisories (September, December, February and August)

- The quality, consistency, and transparency of the capital base will be raised - this will be the focus of this presentation
- Introduce a leverage ratio as a supplementary measure to the Basel II risk-based
- Introducing a series of measures to promote the build up of capital buffers in good times that can be drawn upon in periods of stress

Overview Of Basel III

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- Introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio (LCR) requirement underpinned by a longer-term net stability funding (NSFR) to be discussed by Rosemary Zigrossi

Overview Of Basel III

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- Changes to capital rules related to the trading book, securitizations and counterparty credit risk related to derivative, repos and securities financing activities, will not be addressed in this presentation

- **Timing**

- > Intended to be implemented, subject to certain exceptions and depending on economic conditions, on a phased in basis commencing on January 1, 2013
- > Full implementation of most rules by end of 2018 although phase out of non-qualifying capital instruments will go longer to 2023
- > Appendix 1 provides the details of the phase in period

Timing For Implementation

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- > OSFI expects Canadian banks to comply with the new capital requirements before 2018 but to be able to take full advantage of the phase out period for non-qualifying capital instruments (OSFI's February 1, 2011 letter)
- > OSFI expects Canadian deposit-taking institutions to meet the new capital requirements early in the phase in period through prudent capital retention and capital raising initiatives

- **Introduction**

- > The former definition of capital suffered from certain fundamental flaws:
 - Regulatory adjustments generally were not applied to common equity
 - There was no harmonised list of regulatory adjustments.
 - Weak transparency

- **Key elements of Basel III**

- > The following key changes to the definition of capital were made:
 - The quality and consistency of the common equity element of Tier 1 capital has been significantly improved, with regulatory adjustments generally applied to this element
 - The required features for instruments to be included in Tier 1 capital outside of the common equity element have been strengthened

- Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital (i.e. all capital instruments without conversion features) will be phased out over a 10 year horizon beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year
- Significant capital planning opportunities may exist under the transition rules

- The use of call options on Tier 1 capital will be subject to strict governance arrangements which ensure that the issuing bank is not expected to exercise a call on a capital instrument unless it is in its own economic interest to do so
- Tier 2 will be simplified. There will be one set of entry criteria, removing subcategories of Tier 2
- Tier 3 will be abolished to ensure that market risks are met with the same quality of capital as credit and operational risks

- > Innovative tier 1 capital will not be permitted as the criteria for inclusion in tier 1 additional going concern capital requires that it be perpetual (CRA will not permit an instrument to be debt which is greater than 99 years), prohibits any cumulative features, and if issued by an SPV inter-company instrument must meet the criteria for tier 1 capital (an SPV cannot own shares in the upstream company under Canadian law)

- > There will be no synthetic maturity of tier 2 capital which may affect pricing as investors will be less certain whether the instruments will be redeemed before maturity - issuers will need to consider the regulatory hit for amortization in the last 5 years compared to the current rate environment at the time
- > All non common capital instruments (i.e. preferred shares and subordinated debt) issued after January 1, 2013 will need features which require those instruments to be converted into common shares of the bank if the bank becomes non viable. The detailed requirements are set out in an advisory issued by OSFI on August 16, 2011

- > Elements of capital
 - Total regulatory capital will consist of the sum of the following elements:
 - Tier 1 Capital (going-concern capital)
 - a. Common Equity
 - b. Additional Going-Concern Capital
 - Tier 2 Capital (gone-concern capital)
 - For each of the three categories above (1a, 1b and 2) there will be a single set of criteria which instruments are required to meet before inclusion in the relevant category
 - Rules apply equally to bank holding companies

- Limits and *minima*
 - All elements above are net of regulatory adjustments and are subject to the following restrictions:
 - » Common Equity, Tier 1 Capital and Total Capital must always exceed explicit minima of 4.5%, 6% and 8% of risk-weighted assets, respectively
 - » A capital conservation buffer of 2.5% will be added to common share equity increasing the minimum to 7%, 8.5% and 10.5% respectively (see Appendix 1)

- » A countercyclical capital buffer of 0 - 2.5% to be added when required to common equity Tier 1 capital requirements or possibly to other fully loss absorbing capital which is still under discussion at Basel
- » Systemically important banks will be required to have additional loss absorbing capacity beyond the announced standards of between 1 - 3.5% commencing in 2014. The initial list of 29 banks does not include any banks from Canada but several were likely included in the 73 banks which were evaluated.

- > In addition to significantly increasing the quality and quantity of capital (especially the common share equity requirements), Basel III mandates onerous adjustments to the amount of capital and enhanced disclosure requirements

Regulatory Adjustments Applied To Regulatory Capital

- **Minority interest (i.e., non-controlling interest) and other capital issued out of consolidated subsidiaries that is held by third parties**
 - Common shares issued by consolidated subsidiaries: Minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 only if: (1) the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and (2) the subsidiary that issued the instrument is itself a bank

Minority Interest (cont'd)

- Other Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries to third party investors may receive recognition in Tier 1 capital and Tier 2 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 and Tier 2 capital
- Only that portion of the minority interest which is necessary to meet the minimum capital requirements of that subsidiary is eligible for inclusion in the parent bank. Any excess will not receive any eligible capital treatment in the parent bank

Minority Interest (cont'd)

- The reasoning is that the excess is attributable to minority shareholders and thus is not available to the parent bank
- Treatment is similar for other consolidated subsidiaries which are subject to minimum capital requirements except that no amount can be included as common equity Tier 1
- No capital treatment appears to be given for minority interests in any entity which is not subject to minimum capital requirements
- Conclusion: Third party investors in subsidiaries will not be as desirable under the new rules

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- Goodwill and other intangibles (except mortgage servicing rights discussed later)
 - Goodwill and all other intangibles must be deducted in the calculation of Common Equity Tier 1, including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation.
 - The existing OSFI provision which only requires the deduction for intangibles (other than goodwill) above 5% of Tier 1 capital has been eliminated

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- > Investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation and where the bank owns more than 10% of the entity (likely means the holding of a substantial investment as defined in the Act)
 - Banks should apply a “corresponding deduction approach” to substantial investments in the capital of other banks, other financial institutions and insurance entities where these fall outside of the regulatory scope of consolidation. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- Includes non-controlling substantial investments in banks and securities dealers and all substantial investments in insurance companies. Under current rules these investments are deducted half from Tier 1 capital and half from Tier 2 capital regardless of whether the investment has all been made by way of common shares

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- > Deferred Tax Assets which rely on future profitability of the bank to be realized should be deducted from the Common Equity component of Tier 1. The amount of such assets net of deferred tax liabilities should be deducted
- > Threshold Deductions - 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:

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- 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). The items included in the 15% aggregate limit are subject to full disclosure and are risk weighted at 250%

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

> Comparison to existing OSFI requirement

- Banks are currently required (under OSFI rules) to deduct significant/minority investments and investments in deconsolidated subs from tier 1 (50%) and tier 2 capital (50%)
- Under the December 2009 consultative document, the deduction would come 100% from common equity if the investment was made in common shares of the investee entity (which is most frequently the case)

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- > Comparison to existing OSFI requirement ...*cont'd*
 - The Final Rules Test introduced a 10% individual limit and a 15% aggregate limit to be applied to the three items (Significant investments, DTAs due to timing differences, and mortgage servicing rights)
 - Amounts exceeding these two limits (applying the individual limit first and then the aggregate) would be deducted 100% from common equity

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- > Comparison to existing OSFI requirement ...*cont'd*
 - In comparing the Final Rules Test with existing OSFI treatment, the amount of the deduction would be lower (because of the limits) but the deduction would be from common equity instead of 50% tier 1 and 50% tier 2
 - Therefore, even though the deduction will be lower, depending on the size of the deduction, the new approach may still be more punitive than the existing rules since the deduction will be applied to the bank's common share capital rather than 50 percent from each of tier 1 and 2

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- Investments in own shares (treasury stock)
 - > All of a bank's investments in its own common shares, whether held directly or indirectly, will be deducted in the calculation of Common Equity Tier 1 (unless already derecognized under the relevant accounting standards).
 - > Indirect include investments held in a similar manner to that described in the next section
- Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity. These investments include and are treated as follows:

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- > Investments include direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital
- > Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (eg subordinated debt). It is the net long position that is to be included
- > Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included
- > If the total of all holdings listed above in aggregate exceed 10% of the bank's corresponding capital "bucket" (after applying all other regulatory adjustments in full listed prior to this one) then the amount above 10% is required to be deducted, applying a corresponding deduction approach

Regulatory Adjustments Applied To Regulatory Capital ...*cont'd*

- > Defined benefit pension fund assets and liabilities
 - Defined benefits pension fund liabilities, as included in the balance sheet, must be fully recognized in the calculation of common Tier 1 capital
 - Defined benefit pension fund assets must be deducted from the Common Equity component of Tier 1. Assets in the fund to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank
 - New rules further decrease the attractiveness of defined benefit pension plans in the banking sector

- > Banks will be required to disclose the following:
 - A full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements
 - Separate disclosure of all regulatory adjustments
 - A description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply
 - A description of the main features of capital instruments issued

- banks which disclose ratios involving components of regulatory capital (e.g., “Equity Tier 1”, “Core Tier 1” or “Tangible Common Equity” ratios) to accompany these with a comprehensive explanation of how these ratios are calculated
- > In addition to the above, banks will be required to make available on their websites the full terms and conditions of all instruments included in regulatory capital

- > The leverage ratio is intended to achieve the following objectives:
 - constrain the build-up of leverage in the banking sector, helping avoid destabilising deleveraging processes which can damage the broader financial system and the economy; and
 - reinforce the risk-based requirements with a simple, non-risk-based “backstop” or supplementary measure based on gross exposure
- **Final Rules Text Leverage ratio**
 - > the Committee is proposing to test a minimum Tier 1 leverage ratio of 3% during the parallel run period

- **Transition to the leverage ratio**
 - > The supervisory monitoring period commences 1 January 2011
 - > The parallel run period commences 1 January 2013 and runs until 1 January 2017
 - > 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
 - > OSFI to determine how best to implement the dual leverage ratios in Canada during the parallel run period (OSFI's letter February 1, 2011)

> Capital Conservation Buffer

- A buffer range is established above the regulatory minimum capital requirement and capital distribution constraints will be imposed on the bank when capital levels fall within this range. Banks will be able to conduct business as normal when their capital levels fall into this range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank
- The standard would be based on common equity capital instead Tier 1 or total capital (originally indicated to be based on Tier 1 in the December 2010 Proposals)

Highlights of the Basel III Rules

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- The distribution constraints imposed on banks when their capital levels fall into the range increase as the banks' capital levels approach the minimum requirement. By design, the constraints imposed on banks with capital levels at the top of the range would be minimal. This reflects an expectation that banks' capital levels will from time to time fall into this range. The Basel Committee does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement

Integrating The Countercyclical Capital Buffer And The Capital Conservation Buffer

- (Same chart from the December Basel III Proposals)

Individual bank minimum capital conservation standards (Numbers are illustrative and do not represent a proposed calibration level)	
Capital conservation range is established above the minimum requirement	
Amount by which a bank's capital exceeds the minimum requirement in terms of a percentage of the size of the conservation range	Minimum Capital conservation Ratios (expressed as a percentage of earnings)
[< 25%]	[100%]
[25% - 50%]	[80%]
[50% - 75%]	[60%]
[75% - 100%]	[40%]
[> 100%]	[0%]

Implementing the Countercyclical Capital Buffer Add-on

- Following the building block approach established by the Basel Committee, the buffer is designed to be able to sit on top of the capital conservation buffer. This means that the countercyclical capital buffer is presented as an add-on to the capital conservation buffer, effectively stretching the size of its range
- To use an example, common equity is set at a minimum of 4.5% and the capital conservation buffer has been set at 2.5% of risk weighted assets. Under this scenario a bank with a common equity capital ratio of 7.5% would not be subject to any restrictions on distributions of capital as restrictions are only imposed in the range of 4.5% – 7%

Implementing the Countercyclical Capital Buffer Add-on ...*cont'd*

- Now assume that this bank becomes subject to a countercyclical capital buffer add-on of 2%. The consequence of this is that the range in which restrictions on distributions are imposed becomes 4.5% – 9%. Now the bank with a common equity capital ratio of 7.5% is in the third quartile of this range and so, using the numbers in the table above, would be required to conserve 60% of earnings
- To allow banks time to adjust to a buffer level that exceeds the fixed capital conservation range, they would be given 12 months to get their capital levels above the top of the extended range (common equity above 9% in the example), before restrictions on distributions are imposed

Implementing the Countercyclical Capital Buffer Add-on ...*cont'd*

- This period of grace is intended to help reduce the chances that the market will view the countercyclical capital buffer add-on as a new minimum and avoid a rise in the buffer add-on in one jurisdiction having the potential to require banks to automatically restrict distributions, while being short enough to help ensure that the buffer is accumulated in time to cope with turns in the credit cycle
- During this 12 month period, banks will have the options of meeting the requirement through retaining earnings, raising capital or cutting lending growth. All three of these actions would seem to reinforce the objective of protecting the banking sector from periods of excess credit growth

Implementing the Countercyclical Capital Buffer Add-on ...*cont'd*

- The effect of the above is that at any point in time, the sum of the capital conservation and countercyclical buffer requirements will set a target ratio. In 12 months time banks will need their reported common equity capital ratios to be above this target ratio to avoid becoming subject to restrictions on distributions implied by the position of their common equity capital ratios after 12 months relative to that target ratio
- However, it is important to ensure that banks will not need to wait 12 months before benefiting from the decision of a jurisdiction to release the buffer requirement. As a consequence the common equity capital ratio below which restrictions will apply at any point in time is capped at the target ratio applicable in 12 months time

OSFI Advisory Interim Capital Expectations (September 15, 2010)

- Since October 2008, OSFI has been promoting increased conservatism in capital management
- OSFI will no longer require the increased conservatism in capital management announced late in 2008 but OSFI will require banks to
 - > have prudent internal capital targets that incorporate:
 - the impact of the most recent regulatory reform information from Basel and OSFI;
 - expected market requirements arising from such reforms; and
 - the impact of any proposed transaction

OSFI Advisory Interim Capital Expectations ...*cont'd*

- > via an up-to-date capital plan, prepared in accordance with OSFI's guidance on Internal Capital Adequacy Assessment Program (ICAAP), that they would have sufficient capital to meet their internal capital targets at all times while taking into account:
 - current regulatory requirements and the most recent regulatory reform information from Basel and OSFI;
 - the full transition period required to implement such reforms;
 - due consideration of possible alternatives related to finalizing such reforms; and
 - due consideration of remote but plausible business scenarios that may adversely affect their ability to comply with current and reformed regulatory rules

OSFI Advisory Basel III Implementation (February)

- OSFI expects institutions to meet new capital requirements before 2019
- OSFI will consider transition to the new asset to capital multiple (ACM) regime and streamline dual reporting during the observation period
- OSFI expects to engage in public consultation during 2011 with respect to the implementation of the liquidity coverage ratio in 2015 and the net stable funding ratio in 2018

OSFI Advisory Re Treatment Of Non-Qualifying Capital Instruments (February)

- OSFI provided more detail on expected transition provisions for non-qualifying capital instruments
- OSFI expects banks to manage capital position to minimize the amount of capital redeemed using a “regulatory event” redemption at par
- Create some capital planning opportunities regarding issuing capital prior to January 1, 2013 without conversion features depending on the maturity profile of existing instruments

OSFI Advisory Contingent Capital (August)

- OSFI provides further clarity on Basel minimum requirements
- Applies to all deposit-taking institutions not just internationally active banks
- Requires all non common capital instruments (preferred shares and subordinated debt) issued after January 1, 2013 to have these features in order to qualify as capital

Annex 1

Calibration of the Capital Framework Capital requirements and buffers (all numbers in percent)			
	Common Equity (after deductions)	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

* Common equity or other fully loss absorbing capital

Annex 1

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

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