# The Road to Basel III – Quantitative Impact Study, the Basel III Framework and Implementation in the EU

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*In response to the financial crisis, the Basel Committee on Banking Supervision (BCBS) in December 2009 published its first consultative proposals to review the Basel II regulatory framework. Following a consultation process and a quantitative impact study (QIS), on December 16, 2010, the BCBS published the final Basel III framework for tightening the globally applicable capital adequacy and liquidity rules. The implementation of the new provisions in the EU is currently under way. The European Commission's legislative proposals are expected to be published before summer 2011.*

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The reform package making up Basel III is intended to make the global banking sector more stable and less vulnerable. To this end, the Basel Committee on Banking Supervision (BCBS) has worked out a comprehensive set of measures. The core components of the Basel III rules are revised capital adequacy standards, new liquidity ratios and adjustments to risk-weighted assets. To estimate the quantitative impact of the new rules, both the BCBS and – on behalf of the European Commission – the Committee of European Banking Supervisors (CEBS, the forerunner of the newly established European Banking Authority, EBA) carried out quantitative impact studies (QIS) in collaboration with national supervisory authorities.

The BCBS's globally conducted QIS covered 263 banks in 23 countries while the CEBS QIS involved 230 banks from 21 European countries. Of these banks, 18 were from Austria, which is not a BCBS member. Both studies differentiated between banks with tier 1 capital above EUR 3 billion (Group 1) and all other banks (Group 2). The data were collected on a consolidated basis. The two studies included every Group 1 bank of the relevant countries. Their results cannot be understood additively, as some countries' data were recorded in both studies. The two studies examined the effects of the Basel III rules on a synthetic bank (the aggregate of all banks), without taking into account any transitional arrangements.

On the basis of feedback following the consultations and the data collected in the QIS, the BCBS amended its consultative proposals on Basel III, the agreement on which was reported in two press releases (in July and September 2010 respectively). The final Basel III text published in December 2010 includes all the amendments and some clarifications of previously ambiguous provisions. Furthermore, on January 13, 2011, the BCBS issued a subsequent press release concerning the loss absorbency of additional tier 1 and tier 2 capital upon the occurrence of a specific trigger event (point of non-viability).

## Capital

In the points below, the final Basel III framework differs significantly from the original consultative document:

– The method used to calculate eligible minority interests is clarified in the final rules: Minority interests up to

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the minimum capital requirement (including the capital conservation buffer) of the subsidiary have unlimited prudential recognition; excess capital is recognized up to the percentage of capital which is held by the consolidated group (calculated in respect of common equity tier 1, tier 1 and total capital). The calculation of minority interests that receive recognition is based on the minimum capital ratios including the capital conservation buffer. The consultative document of December 2009 did not recognize minority interests at all, the latter were subsequently permitted limited recognition provided they did not exceed the minimum capital ratio of a subsidiary bank; in other words, the capital conservation buffer was not taken into account. In contrast to the original proposal, the new rule governing minority interests shows a certain lenience.

– The items that may receive limited recognition, which were mentioned in the press release of July 2010, are specified further in the final rules. The 10% cap represents an easing, as (1) investments of more than 10% in the common shares of unconsolidated financial institutions and (2) investments in insurance companies are not fully deductible as they were under Basel II but must be deducted by the amount exceeding 10% of common equity tier 1 after all other relevant deductions. The amount which is not deducted from common equity tier 1 must be risk-weighted at 250%.
– No further fundamental changes were made to the specific transitional arrangements as published by the BCBS in September 2010. In addition to the already familiar provisions, transitional arrangements were now also stipulated for minority interests and regulatory deductions which must be carried out if the thresholds are exceeded. For both these rules, progressive adjustments in steps of 20% will apply until January 1, 2018. Current government capital injections will be grandfathered until January 1, 2018.
– The capital conservation buffer (CCB) is set at 2.5% and must be met with common equity tier 1. When capital levels fall within this range, capital distribution constraints will be imposed, which are subdivided into quartiles and gradually increase as the capital levels approach the minimum requirements. Disbursements constraints start when the 7% mark (common tier 1 of 4.5% and CCB of 2.5%) is undershot: 40% of earnings (dividend payments, share buybacks, bonus payments etc.) may not be distributed. If the capital ratio falls below 5.125%, 100% of the earnings must be reinvested automatically.
– The countercyclical capital buffer is set at the national level and can vary between zero and 2.5% (although a footnote states that this buffer can be set higher, if deemed necessary). The buffer must be met with common equity tier 1 capital or other fully loss-absorbing capital (a more detailed definition of this concept is to be specified by the BCBS). The document entitled "Guidance for national authorities operating the countercyclical capital buffer," which includes principles for setting the buffer amount, was published together with the final Basel III rules.
– On January 13, 2011, the BCBS issued a press release announcing that the list of criteria for additional tier 1 and tier 2 would be amended. All additional tier 1 and tier 2 instruments issued by an internationally

active bank must either be written off or converted into common equity by the relevant supervisory authority upon the occurrence of a "trigger event" (point of non-viability). The trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

The QIS data were evaluated on the basis of these amendments, and the capital ratios were published in accordance with the new definitions and after transitional arrangements.

Both the BCBS and the CEBS studies show that the impact of the new framework on Group 1 banks – in common equity tier 1, tier 1 and total capital – is much more pronounced than on Group 2 banks.

At the European level (Group 1 banks and Group 2 banks), the additional requirement in common equity tier 1 capital under Basel III amounts to EUR 62 billion and, on inclusion of the capital conservation buffer, to EUR 291 billion, respectively; Group 1 banks alone account for an additional capital requirement of EUR 53 billion and EUR 263 billion, respectively. By comparison, the additional common equity tier 1 needed by banks worldwide (BCBS study) is significantly higher (EUR 173 billion plus a capital conservation buffer of EUR 602 billion); Group 1 banks alone account for EUR 165 billion and EUR 577 billion, respectively.

An extrapolation for the entire Austrian banking sector, which the OeNB carried out using QIS figures, showed that domestic banks would require an additional EUR 15 billion to EUR 18 billion. (Unlike the aforementioned QIS figures computed by the BCBS and CEBS, this figure comprises not only common equity tier 1 but also additional tier 1 and tier 2 capital.)

## Liquidity

The BCBS addressed the vulnerabilities revealed by the liquidity crisis from mid-2007 on by introducing two ratios, which are to be globally applicable minimum requirements in the national supervisory arrangements. As a result, for the first time there is a globally uniform, binding liquidity standard as an independent pillar equivalent to the one in place for capital requirements.

The aim of the short-term liquidity coverage ratio (LCR) is to ensure that banks remain liquid in a predefined scenario of idiosyncratic and market-wide shocks over a period of 30 days. The aim of the net stable funding ratio (NSFR) is to ensure the medium-to-long-term liquidity of banks. The structure of this ratio was designed to promote stable medium-to-long-term funding over short-term forms of funding.

Compared with the original proposal at end-2009, major changes were made to the final Basel III documents published in December 2010. These changes concerned various run-off rates in respect of LCR and NSFR, a cap[2] on total LCR inflows, information concerning the treatment of liquidity flows in institutional networks of cooperative banks[3] and the treatment for jurisdic-

[2] *Under the LCR, only 75% of cash outflows may be covered by cash inflows, thereby ensuring a minimum liquid funds buffer.*

[3] *In respect of LCRs, asymmetrical run-off factors for cash inflows and outflows apply to banks within a decentralized liquidity pool. Decentralized liquidity pools were not recognized as a "group or group of credit institutions".*

tions with insufficient level 1 assets in local currency. Furthermore, definitive details on some matters – such as quantitative criteria, fundamental and market-related characteristics of liquid assets and certain space for maneuver of supervisory authorities – have been left open.

Although Austria's average results in the EU QIS did not reach the 100% mark, they exceeded the European average.[4] The calculations did not include all the proposals published in December 2010. It was also difficult to ensure data quality for each country, and individual items permitted considerable scope for interpretation. The OeNB therefore expects that the results could still change.

Compared with the aforementioned capital requirements, many issues regarding LCR and NSFR ratios are still undefined and unclear. Current debate reveals that presently banks and supervisory authorities have diverging views regarding the calculation of these ratios. The OeNB therefore welcomes the QIS as well as the observation period for the purposes of fostering discussion and exchange between all stakeholders.

The OeNB does not expect these two new ratios to bring about a sea change in Austrian banks' business models. The current liquidity buffer's composition and small adjustments to the refinancing structure (maturity transformation, less dependence on the wholesale market etc.) could trigger a rise in costs. At the same time, improvements in both the data situation and data quality will enhance internal reporting in the banking sector.

## Implementation in the EU

The transposition of Basel III into EU legislation is currently under way. This is why it is too early to ascertain the extent to which deviations from the Basel rules may occur. The European Commission's corresponding legislative proposals are expected to be published before summer 2011. The new rules are scheduled to be applicable from January 1, 2013.

[4] *For Group 1 and Group 2 banks, average LCR and NSFR values ranged between 83% and 97%. In respect of NSFRs only, Group 2 banks were below the EU average.*