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2013: The year of regulatory easing?

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Introduction

As we enter 2013, the regulatory environment remains a significant source of debate for bank stakeholders across the globe. In this article, we present a summary of the main developments expected to affect regulation in 2013, focusing in particular on trading and banking books aspects, both areas of specific expertise for Solum Financial.

Significant uncertainty remains, however, as both the implementation timeline and the rulebooks' final contents remain in a state of flux. This affects a wide array of jurisdictions, and both national and international regulatory bodies. Most importantly, throughout the second half of 2012, a consensus has steadily emerged that some of the originally intended implementation deadlines would be very difficult to meet. In addition, resistance from the banking industry and from its clients and end-users against various parts of the regulatory proposals (the recently revamped liquidity rules being an example of such opposition) has continued to increase. We remain therefore mindful that the snapshot presented below is very likely to evolve throughout the year, as the calendar of events continues to be impacted by delays, industry pushback and other policy adjustments.

Despite the overall uncertainty, we expect that as has already been the case with the re-definition of liquidity requirements, 2013 will provide clarifications on a handful of topics, namely risk-weighted asset (RWA) harmonisation, trading book and securitisation reviews and the CVA non-financial counterparties exemption.

Basel III

- ***2013 kick-off highly doubtful***

The phasing in of the Basel III rulebook, which was supposed to take place in January 2013 (see Appendix for a detailed implementation timeline) is now in doubt as full legislative adoption has been delayed in many jurisdictions and technical implementation roadblocks remain. While no official decision has been taken at the time of writing, we suspect the 2013 kick-off is likely to be delayed by many months, possibly an entire year (or more).

- ***Liquidity Coverage Ratio (LCR)***

Ever since the concept was first introduced in the initial Basel III document, mandatory liquidity requirements have been a key contentious issue between regulators and the industry, as well as a source of disagreement between various policymaking bodies. Driven mainly by the desire to see banks hold larger liquidity pools than was the case prior to the 2007/08 financial crisis, the LCR requires that banks hold at all times a large enough stock of "high quality, liquid and unencumbered assets" to cover total net cash outflows over a 30-day period.

Beyond the technical difficulties associated with properly assessing net cash outflows under a stressed scenario, the generic concept of attempting to establish global liquidity standards has been criticized by parts of the banking industry, mainly for what many believe is a too restrictive definition of the concept of "liquid assets", and for the potential unintended economy-wide consequences of banks holding large pools of capital aside at the same time as the stagnating lending capacity of the industry is stifling economic growth.

Moreover, many have pointed out the inconsistency between stringent eligibility criteria under Basel III liquidity rules and the sometimes much looser rules imposed by central banks for their own repo operations. High quality asset-backed securities are a case in point, as high-quality bonds were until recently excluded from the LCR ratio (except for covered bonds, and even then only as Level 2 assets) while they are included in ECB eligibility criteria and can be used as collateral in Eurosystem operations.

As a result of this early criticism, the asset mix had already been slightly expanded in iterations of the Basel III rulebook (introducing the concept of Level 1 and Level 2 assets, with the latter eligible up to a cap of 40% of the aggregate liquidity buffer and at a 15% discount to nominal value). The timetable had also been extended once, with the LCR requirement expected to go live starting in 2015.

In very recent news[1], the Basel Committee appears to have relaxed liquidity rules further. Indeed, while the concept of minimum liquidity standards as a core requirement of the Basel III package is reaffirmed, both the eligibility criteria and the timeline to full implementation have been significantly altered.

[1] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (Basel Committee, 7 January 2013)

On the eligibility front, the list of high quality liquid assets is expanded further with the addition of "Level 2B assets", defined as unencumbered equities and corporate bonds rated between A+ and BBB- (both with the same 50% haircut), and select residential mortgage backed securities rated AA and above (with 25% haircut). Level 2B assets will be subject to a limit of 15% of the total liquidity pool, after haircuts.

As for the implementation timeline, 2015 as the kick off date is reaffirmed but the minimum LCR required as of that date drops to 60% (vs. 100% in the initial rules), with increments of 10% per annum bringing the minimum requirement to 100% as of January 2019 - in line with the staggered increases in the minima required for capital ratios (please refer to the Appendix for the detailed implementation timeline).

This new and likely final set of rules on liquidity sets a great example for the type of regulatory developments expected in 2013, where regulatory bodies continue to fine tune the contours of the rulebooks (with somewhat of a bias towards relaxation of the original rules), with important business model and operational consequences for the supervised banks.

- ***RWA harmonisation***

A key concern of opponents to the Basel III regime (and to Basel II, for that matter) has been the wide discrepancies observed in RWA computations over the years. Given the key role that risk measurement in general, and RWAs in particular, are playing in the determination of capital ratios, the push towards harmonising these metrics both across jurisdictions and on an individual bank basis has strong merit.

The divide between the standardised and the Internal Ratings-Based (IRB) approaches under Basel II, whereby banks can compute their own estimates for probability of default (PD) and loss given default (LGD) assumptions in their loan portfolios, is the primary driver of this, as banks reporting under Basel II have increasingly adopted the IRB approach in order to capture the banking book benefits of using more relaxed assumptions than under the standardised rules.

A study published by the International Monetary Fund[2] in early 2012 highlighted that the ratio of RWAs to total assets (a handy snapshot of a given bank's risk profile, as a higher ratio should theoretically indicate a portfolio mix weighted towards riskier assets) had steadily eroded over the past decade, both on an absolute basis across jurisdictions, but also for certain regions relative to others (with the drop-off most pronounced for European institutions, unsurprisingly given that US banks still report their numbers in a standardised Basel I universe).

While these discrepancies can be explained away by the differences in business models and by legitimate improvements in the quality of the data and models used to produce those PD and LGD estimates, the lack of harmonisation across jurisdictions and individual institutions remains a key issue for regulators and a likely source of further changes in the regulatory framework as the issue gets investigated further.

Ideas already introduced in some countries include a mandatory RWA floor for certain class of assets. While the topic is only in its infancy in terms of policy discussion, let alone implementation, 2013 should see some explicit proposals arise in this area, with the likely wide-ranging implications for capital ratios, especially in jurisdictions and individual institutions that have most aggressively optimised Basel II banking book RWA rules.

- ***Fundamental review of the trading book***

One of the two key papers published by the Basel Committee over the past year has been the long awaited fundamental review of the trading book, published last May. While this remains at the proposal stage (comments from the industry were due by the end of the third quarter of 2012 and the final rulebook has not been published yet), the potential repercussions are very important.

Trading book risks have been a key area of concern for regulators in the past few years, given the extent to which they have caused material capital losses in the 2007/08 financial crisis (mostly as a result of 1) undercapitalisation of counterparty risk and 2) undercapitalisation of certain structured assets as a result of the large discrepancies between trading and banking book capital treatment – which had incentivized financial institutions to classify a number of illiquid banking assets as trading book ones).

[2] Revisiting Risk-Weighted Assets – Why do RWAs Differ Across Countries and What Can Be Done About It (IMF Working Paper, March 2012)

Both points have been partly addressed in the updated market risk rules: 1) the former under the broad review of counterparty risk and the introduction of CVA specific capital charges (as we have discussed in further detail in our November paper[3]), and 2) the latter through the re-alignment of banking book and trading book capital treatment for securitisation assets – the so-called "Basel 2.5" market and securitisation rules.

The fundamental review of the trading books goes much further however, and is likely to incorporate major changes to trading book risk measurement, including but not restricted to the following topics highlighted in the May proposal:

- **An objective regulatory distinction between trading book and banking book assets**, in order to avoid the regulatory arbitrage of the 2000s where banking book assets were aggressively classified as trading book assets to benefit from lighter capital charges (or the potential capital arbitrage introduced by CVA/CCR rules, where the punitive capital costs of counterparty risk may lead financial institutions to open credit lines – i.e. banking book assets – to help a given counterparty to fund the collateralisation of capital-heavy trading book exposures)

- **The shift towards expected shortfall measurement, in lieu of the prevailing VaR methodologies,** with the expectation that such a change should lead to a more accurate assessment of tail risks, and would also discourage the suboptimal behaviour encouraged by certain weaknesses of VaR methodologies (such as non sub-additivity).

- **The calibration of both standardised and IRB approaches to financial assets behaviour in periods of great stress** (consistently with the stressed VaR (sVaR) concept introduced in the "Basel 2.5" revisions)

- **The reduction of model risk in the IRB approach,** including a more detailed and granular approval process for internal models

- **The expansion of risk sensitivities in the standardised approach,** so as to reduce the large discrepancies with the IRB approach

We expect the final rules and the implementation schedule to be made public in 2013, and we will comment in more detail in further papers.

- ***Securitisation risk weights***

The second key consultation paper published by the Basel Committee over the course of 2012 came at the end of the year, with the comprehensive review of the capital treatment for securitised assets. As discussed above, the asset class had already undergone some broad changes under the Basel 2.5 revisions, but the current proposal represents a more comprehensive methodology review, which attempts to address the many shortcomings of the blunt ratings-based approach that has characterized the capital treatment of asset-backed securities under the Basel II framework.

Under this new securitisation framework, two possible hierarchies are being proposed (with the Basel Committee seemingly very focused on avoiding the creation of systematic capital incentives that would favour one approach over the other).

In the first alternative, banks would follow the Modified Supervisory Formula Approach (MSFA), which basically addresses some of the shortcomings of the Supervisory Formula Approach (SFA) already used for the capital treatment of certain securitised assets in the Basel II Accord. These improvements mostly revolve around the incorporation of maturity effects (whereas the original SFA was based on a 1-yr default mode model) and a more stringent criteria with respect to the assessment of IRB capital requirements at the underlying asset level (a key point of criticism against the Supervisory Formula Approach (SSFA) has been its very high sensitivity to initial inputs in certain cases). Failing approval to use the MSFA, the fall-back option would then be either the revised Ratings Based Approach (RBA) or the Simplified Supervisory Formula Approach.

[3] CVA VaR Capital Charges – A Comparative Analysis (Solum Financial Partners, November 2012)

In the second alternative, banks would be required to differentiate between so-called “senior high-quality tranches” (typically AA- and above) and other securitised assets, and then apply the revised RBA or the MSFA/SSFA for the former and a concentration ratio approach based on underlying assets’ capital requirements for the latter.

In both hierarchies, supervisors can restrict or prohibit the use of both Supervisory Formula Approaches (Modified and/or Simplified) depending on the type of structure or transaction, again, with a view to contain the model risk embedded in those approaches.

Importantly, all securitisation exposures would generally be subject to a 20% supervisory risk-weight floor, regardless of the hierarchy or whether the given bank is under standardised or IRB treatment (the latter used to enjoy a 7% risk-weight floor under the Basel II rules).

While the technical details remain to be analysed more thoroughly, the new rules, if implemented as proposed, will broadly result in the following:

- **Overall capital requirements for securitised products are likely to increase**, although there are some exceptions on an individual asset basis, it is likely that the capital held by banks against such products is going to head higher in aggregate, if only as a result of the 20% RW floor.
- **The reliance on external ratings is vastly reduced,** as internal risk characteristics of the specific securitised tranche become a larger driver of capital charges
- **The well-known cliff effect around the IG/sub-IG point is reduced,** if not suppressed altogether
- **The recognition of the leverage effect is increased,** resulting in lower capital charges for first-priority bonds even when the rating is low, and higher capital charges for non-senior bonds even when those are highly rated
- **The recognition of maturity and tranche thickness (both absent from the ratings-based Basel II approach) is improved,** resulting in a capital framework somewhat closer to the supervisory formula for unrated securitised products

The resulting proposed capital charges, as highlighted in the figures below for the revised RBA, result in proposed capital charges moving higher across the board, senior bonds (i.e. first-pays) being impacted less than non-senior bonds, and those first-pays where ratings are sub-investment grade seeing charges actually improve (as they were implying up to full capital deduction in the Basel II/2.5 framework).

Comments to the proposals are expected to be sent to the Basel Committee by March 2013, so that further clarity on the final rules can probably expected by the second half of 2013. There too, given the likely implications for banks and their portfolios, especially as institutions continue to grasp with their legacy books, we expect to explore the subject in further detail in this space in the coming months.

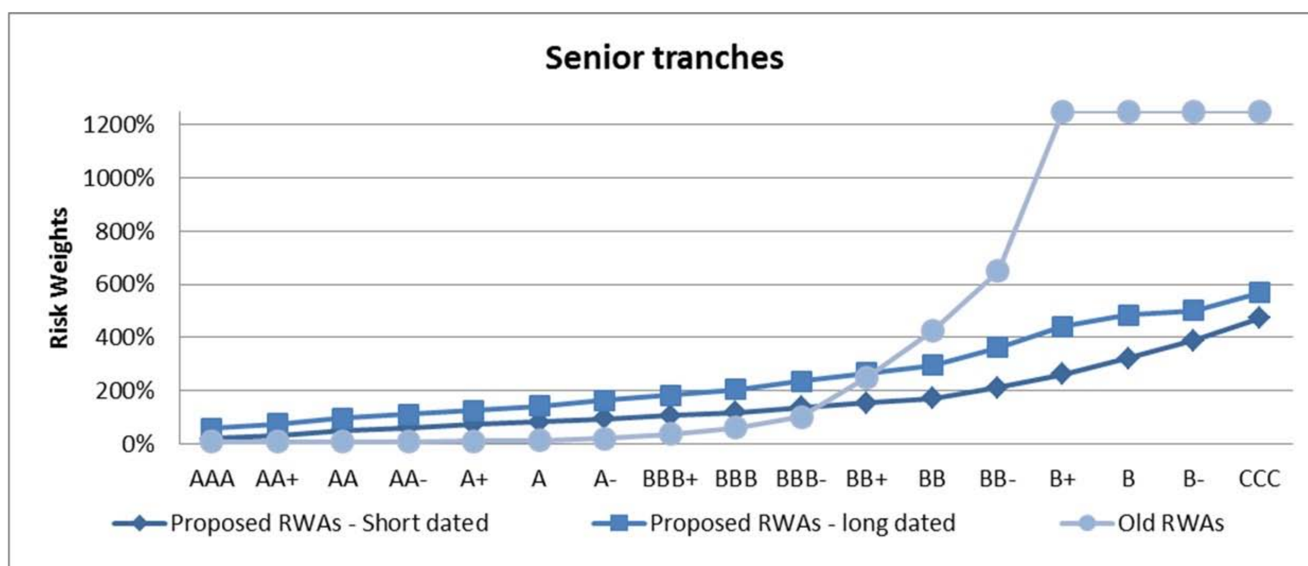

Chart 1: *Revised Ratings Based Approach proposal for securitisation risk weights (senior tranches)*

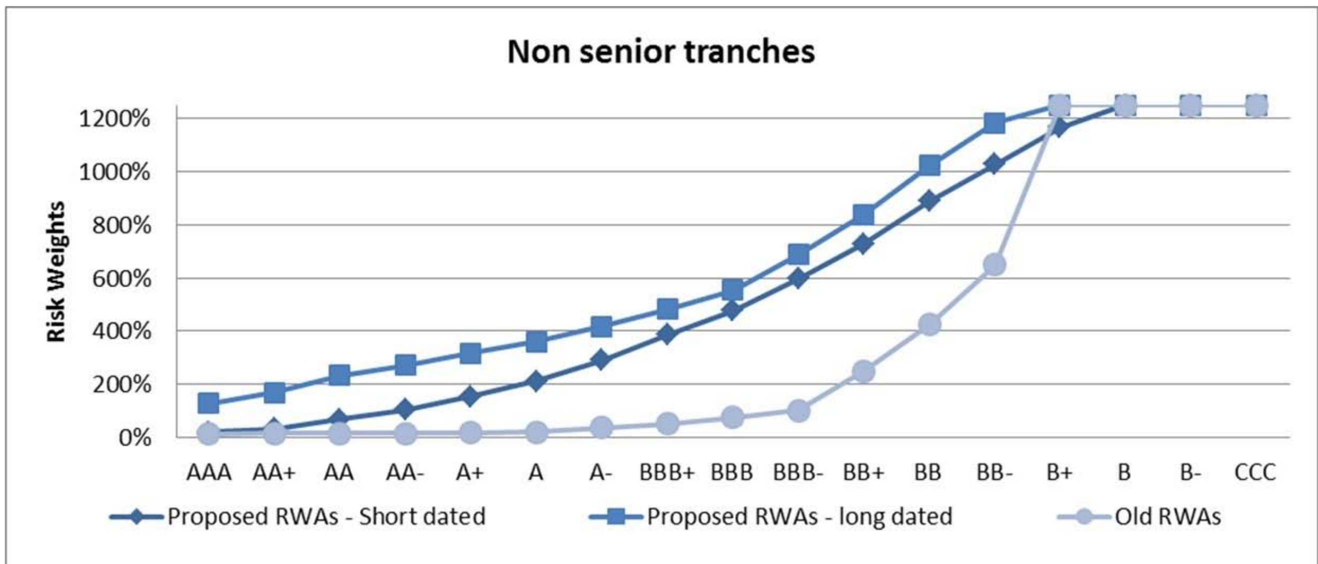

Chart 2: *Revised Ratings Based Approach proposal for securitisation risk weights (non-senior tranches)*

CVA

Part of the Basel III overhaul of bank capital requirements is the CVA capital charge which is an additional regulatory capital charge to be added to the existing default charge (see our paper "The Different Guises of CVA"[4] for further detail). One important issue surrounding the CVA capital charge (which has been attracting attention from most CCR/CVA practitioners throughout 2012) is the exemption in Europe from retaining capital against CVA generated by non-financial counterparties. This topic is likely to see clarity in the near to medium term, either as an exemption in line with the treatment already awarded to sovereign entities in Europe, or for the CVA capital charge for non-financial counterparties to be maintained.

It is not clear at this stage whether the final CRD IV rules (which implement the Basel III rulebook into EU law) will incorporate this so-called 'corporate exemption', but as the CRD IV package progresses through the European Commission, the European Parliament and the Council of the European Union (although not in time for January 2013 adoption as was initially decided), the guidance on this topic is likely to become clearer fairly soon.

Given that the incremental capital costs under the new CCR/CVA regime mostly arise from uncollateralised trades (more likely to take place with a non-financial end-user given working capital constraints than with a financial counterparty), the adoption of the non-financial exemption could have a potentially significant impact on counterparty credit risk regulation. Indeed this would in all likelihood maintain the status quo on the corporate front, with OTC derivatives trades agreed upon on a bilateral basis between banks and corporate entities, leaving the sole inter-dealer market as the centre of central clearing and collateralisation concerns.

The potential impact on the CDS market as a whole of not exempting non-financial entities is another important factor to consider. As banks buy protection on these entities to hedge non-financial counterparty exposures and mitigate their CVA VaR charge, the CDS bid thus created may lead to the kind of "doom loop" which has led to the sovereign exemption in the first place, where CDS spread widening begets further CVA VaR hedging begets further spread widening. From the policymakers' point of view, the trade-off between increased financial stability with respect to counterparty risk and the potential negative implications for the market-based creditworthiness of certain counterparties remains an unresolved question.

ECB as the common regulator

In their attempts to de-link bank risk from sovereign risk and break the vicious circle that has plagued the European Union in recent years, European regulators have recently made moves towards appointing the ECB as the common regulatory body for all large banks in the Eurozone. Initially planned to take place in early 2013, this shift toward consolidated banking supervision in the Eurozone is likely to occur later in the year at best, as the framework (both legal and political) for such a transformation remains unclear.

[4] "The Different Guises of CVA" (Solum Financial Partners, December 2012). Please refer to Solum Financial Partners' website for further details

It is also likely that for a possibly relatively long period, the ECB will continue to delegate supervisory powers to the national regulators, while it builds the required expertise and infrastructure to be able to undertake such a task itself. Other items remain on the European policymaking agenda beyond these first steps towards a banking union, such as the establishment of a resolution framework for failing banks and ultimately some form of EU-wide deposit protection. Such elements remain highly political, and predicting their outcome is well beyond the purpose of this article.

Nonetheless, the move towards the single supervisor model should, all others thing being equal, harmonise the playing field. In the long run, as bank stakeholders start focusing on individual banks rather than shunning entire banking sectors because of the status of their respective sovereign states, this should start benefiting the strong banks from weak countries, and likely put the spotlight on the weaker banks from stronger countries.

CRD IV adoption

The adoption of the capital directive, which adapts the Basel III agreement into EU law, is another expected event for the early part of 2013 – albeit delayed from the initial January target date. There are a number of areas where the final decisions could affect national implementation of the Basel III rules, including the technical details of LCR/NSFR and the leverage ratio – and as detailed above, potential exemptions under the CCR/CVA capital requirements.

More importantly, the degree of freedom left to member states with respect to the national application of the supervisory rules remains an open topic, with some countries arguing for greater flexibility so that they can impose more stringent rules on their own banks. The extent to which new rules level the playing field across jurisdictions and between individual banks is a key aspect of regulatory change. In this context, any move towards greater differentiation in the national interpretation of supervisory rules (as already seen for capital ratios with the various national "finishes") would have large repercussions on how banks operate and how business models are shaped depending on the jurisdiction.

Appendix

		2013	2014	2015	2016	2017	2018	2019
Common Equity	Deductions from Common Equity		20%	40%	60%	80%	100%	100%
	Common Equity Capital Ratio	3.5%	4%	4.5%	4.5%	4.5%	4.5%	4.5%
	Capital Conservation Buffer				0.625% increments p.a.			2.5%
	Total Minimum Common Equity	3.5%	4%	4.5%	0.625% increments p.a.			7%
Total Capital	Phasing out of T1/T2 ineligible instruments	Phased out from 2013 onwards (10% a year, to 2023)						
	Tier 1 Ratio	4.5%	5.5%	6%	6%	6%	6%	6%
	Total Capital Ratio	8%	8%	8%	8%	8%	8%	8%
	Total Capital Ratio + Conservation Buffer	8%	8%	8%	0.625% increments p.a.			10.5%
Additional Buffers	Systemic Buffer (G-SIB)				Up to 3.5%			
	Countercyclical Buffer				Up to 2.5%			
Liquidity & Funding	Liquidity Coverage Ratio	Observation		60%	70%	80%	90%	100%
	Net Stable Funding Ratio	Observation					Min. Standard	
Leverage	Leverage Ratio	Parallel Run to 2017; Disclosure from 2015					Pillar 1	

Table 1: *Summary of Basel III current implementation schedule*

Summary

In this paper, we have attempted to highlight the most important regulatory changes that are expected to impact banks in the coming year. The regulatory agenda, both on final contents and implementation timeline, remains very uncertain, but we expect some form of clarification on many issues affecting risk measurement and capital ratios in 2013. Those key areas of focus for risk practitioners and banks' senior management alike are the push for RWA harmonisation, the redefinition of trading book rules and of the securitisation capitalisation framework, as well as the agreement on the future of liquidity requirements.

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