LATHAM & WATKINS

Number 1138 3 February 2011

Client Alert

Latham & Watkins
Finance Department

Basel III: A New Environment for International Banks

> "Basel III will make most banking activities more capital intensive and expensive, particularly activities undertaken in the trading book. However, it will probably also make banks more stable."

On December 16, 2010 the Basel Committee on Banking Supervision (the Committee) issued two publications containing the final text of a wide-ranging update of the 2004 Basel II Accord. On 13 January 2011, the Committee issued an Annex containing the final elements of reform to the redefinition of regulatory capital. The three publications, collectively known as Basel III, change significantly the capital, liquidity and leverage rules for international banks.

Basel III follows two earlier publications modifying the Basel II Accord (sometimes referred to as Basel 2.5) issued by the Committee in July 2009. Because both Basel 2.5 and Basel III represent updates rather than self-standing sets of rules, much of the Basel II framework remains in place and is summarized briefly in the immediately following section of this *Alert*. In this *Alert*, we refer to the Basel II Accord as modified by Basel 2.5 and Basel III as the Basel Accord.

The recent changes to the Basel Accord must, as with Basel II earlier, be adopted into national law or regulation in each jurisdiction before becoming binding on banks supervized in that jurisdiction. This process is already underway. In the European Union, for example, the European Commission has proposed amendments (CRD IV) to the EU Capital Requirements Directive (CRD) for approval by the EU Council of Ministers and the European Parliament. Once approved, the CRD changes must then be adopted into national law or regulation within each of the 27 EU Member States. The situation in the United States is at least as complex. The US is currently grappling with how to harmonize the new Basel Accord with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) enacted in mid-2010. While Dodd-Frank and the Basel Accord are largely consistent in requiring more stringent prudential standards, including capital and liquidity, and a non-risk weighted leverage ratio, the two frameworks do not mesh perfectly and will be a challenge to harmonize.

The need to adopt the Basel Accord into national legislation or regulation raises the distinct possibility of inconsistent adoption. Not only are there strong political and commercial forces at play in a highly uncertain micro- and macro-economic climate, but a handful of fundamental questions remain unanswered in the Basel Accord itself (such as whether banks of different size or focus should be treated equally under the new rules). With the objective of achieving as much consistency of adoption as possible, the Committee has tasked its Standards Implementation Group with issuing a standards surveillance framework later this year.

This *Alert* provides a very high level summary of the changes to the Basel Accord and notes some of the most significant new requirements in CRD IV and Dodd-Frank. For a more comprehensive description of the changes click here; for the combined Basel 2.5 text click here; and for the combined Basel III text click here.

Summary

Basel Accord

The main changes promulgated by Basel 2.5 and Basel III are as follows:

- **Increased overall capital requirement**. Between 2013 and 2019, the common equity component of capital (core Tier 1) will increase from 2 percent of a bank's risk-weighted assets *before* certain regulatory deductions to 4.5 percent *after* such deductions. The overall capital requirement (Tier 1 and Tier 2) will increase from 8 percent to 10.5 percent. Banks will also need to meet a new 2.5 percent capital conservation buffer as well as a zero to 2.5 percent counter-cyclical capital buffer.
- **Narrower definition of regulatory capital**. Common equity will continue to qualify as core Tier 1 capital, but most outstanding hybrid capital instruments (upper Tier 1 and Tier 2) must be replaced by instruments that are more loss-absorbing and do not have incentives to redeem. The distinctions between upper and lower Tier 2 instruments, and all Tier 3 instruments, will be abolished. All non-qualifying instruments issued on or after September 12, 2010, and all non-qualifying core Tier 1 instruments issued prior to that date, will be derecognized in full from January 1. 2013; other non-qualifying instruments issued prior to September 12, 2010 will be phased out at the rate of 10 percent per year from 2013 to 2023, subject to certain exceptions.
- **Increased capital charges for banking and trading book exposures**. Commencing December 31, 2010, re-securitisation exposures and certain liquidity commitments held in the banking book will require more capital. In the trading book, (i) commencing January 1, 2011, banks will be subject to new "stressed" value-at-risk models, increased capital charges and restrictions on correlation trading portfolios, increased capital charges for nth-to-default derivatives and increased capital charges for securitisation exposures, and (ii) commencing January 1, 2013, banks will be subject to substantially increased and expanded counterparty risk charges, including increased charges for exposures to other financial institutions.
- **Two new liquidity ratios**. A new 30-day "liquidity coverage ratio" (LCR) requiring high-quality liquid assets to equal or exceed highly-stressed cash outflows will be adopted from January 1, 2015. A one-year "net stable funding ratio" (NSFR) requiring "available" stable funding to equal or exceed "required" stable funding will be adopted from January 1, 2018.
- **New leverage ratio**. A minimum 3 percent Tier 1 leverage ratio, measured against a bank's gross (and not risk-weighted) balance sheet, will be trialled until 2018 and adopted from January 1, 2019.

In addition to the changes described above, banks in 2010 became subject to various additional legal and regulatory requirements, notably (i) under the revised CRD, a 5 percent risk retention requirement and changes in the definition of qualifying regulatory capital, and (ii) under Dodd-Frank, heightened capital requirements and a broad set of new business restrictions, including enterprise-wide limits on proprietary trading and private equity and other fund investments under the "Volcker Rule" and the swaps push-out rule requiring swap businesses to be transferred to a bank affiliate. Moreover, the Committee is working on various additional projects, described at the end of this *Alert*, that may yield further material changes to the Basel Accord.

In the United States, Dodd-Frank directs the Federal banking regulators to establish minimum leverage capital requirements and minimum risk-based capital requirements for depository institutions, holding companies, and certain systemically significant nonbank financial companies supervised by the Board of Governors of the Federal Reserve. Any new capital requirements are to be no lower than current depository institution leverage capital requirements and risk-based capital requirements. The Federal banking regulators have issued a Joint Notice of Proposed Rulemaking that establishes a risk-based capital floor for those banking organizations that were subject to the advanced approaches rules under Basel II as adopted in the United States. Final rules remain forthcoming, so it remains to be seen to what extent Basel III is adopted in the United States. Under Basel II, the US opted for only partially implementing those final rules and applying them only to the largest and most internationally active US banks.

Changes to the accounting rules applicable to banks are largely beyond the scope of this *Alert*. However, accounting rules will play a larger role than ever before in the determination of regulatory capital because, as noted below, many new provisions in the Basel Accord (such as deductions from regulatory capital) start with a bank's accounting balance sheet treatment. In a significant development, the US Financial Accounting Standards Board (FASB) on January 26, 2011 retreated from its earlier proposal to require banks to hold all of their loans at market value. Instead, banks will be allowed to report some financial instruments on their balance sheets at amortized cost, as they currently do, rather than at fair value. The FASB's original fair-value proposal broke sharply with the proposals of the International Accounting Standards Board (IASB), which preserved cost accounting as an option for basic assets when the holder's objective is to collect the contractual cash flows.

Impact

Basel III will have a profound effect on banking behavior. The changes will make all banking activities more expensive, in particular exposures held in the trading book. The changes will probably also make banks more stable. Given the sheer scope and complexity of the changes, the need to enact the changes into national law (leaving open the possibility of further modification), and the relatively lengthy adoption period, it is at present difficult to predict with much certainty just how banks will respond going forward. However, some likely areas of change are worth highlighting:

- Banks will continue to reduce their cost base in order to bolster returns on equity and to help build up core Tier 1 capital via retained earnings rather than new capital raisings. Equity capital markets are already making judgments about "winners" and "losers" under Basel III. Cost reduction efforts are likely to result in more conservative bonus and other compensation schemes for executives, bankers and other staff.
- Banks will issue newly-formulated hybrid capital instruments to replace existing non-common Tier 1 and Tier 2 capital instruments which will no longer qualify as capital commencing January 1, 2013. Banks will also reduce or eliminate capital deduction items over the same period.
- Banks will continue to de-leverage aggressively — for both regulatory capital and leverage ratio purposes – via sales of assets in both cash and synthetic transactions (*e.g.*, acquiring 0 % to X % credit default swap protection on a portfolio of exposures).
- Banks will develop alternatives to "double-" or "triple-whammy" exposure types (*i.e.*, exposure types that attract heavy capital charges *and* coverage under either the leverage ratio and/or either or both of the liquidity ratios), such as certain unfunded commitments (*e.g.*, backing municipal bond issues, trade finance and corporate commercial paper lines).
- Banks will restructure certain traditional products (such as CDOs and conduits) to avoid rules with the greatest adverse impact (such as the EU 5 percent retention requirement and the re-securitization exposure capital weights).

- Banks will reduce substantially, or even eliminate, activities that result in heavy presumed net cash outflows under the LCR, such as (i) funding raised for the bank under ABS and ABCP programmes and (ii) committed liquidity facilities provided by the bank to non-financial corporates and municipalities.
- Banks will reduce or restructure, or even spin-off, certain heavily capital-intensive trading book activities, such as correlation trading.

Continuing Basel II Framework

As mentioned above, much of the Basel II framework will remain in place, including:

- **Three Pillars of Regulation**. Pillar I (Regulatory Capital Charges) imposes minimum capital requirements on credit, market and operational risks to reduce impact of losses on exposures. Pillar II (Supervision) imposes more specific bank supervision to promote better risk management. Pillar III (Disclosure) imposes market discipline through greater public disclosure.
- **Types of Banks**. So-called “Standardised Banks”, which have the least sophisticated capital calculations and generally the highest capital burdens, determine required capital levels largely on the basis of external ratings. More advanced banks (referred to as “internal ratings based banks” or “IRB Banks”) determine capital charges using sophisticated formulas that are more credit risk sensitive, with “Foundation IRB Banks” using mostly supervisor-imposed inputs and “Advanced IRB Banks” using mostly self-determined inputs. Every bank is categorized as a Standardized Bank under the Basel Accord unless its supervisor gives it specific approval to determine its capital requirements as a Foundation IRB Bank or an Advanced IRB Bank.
- **Banking Book and Trading Book**. All exposures not held in the trading book must be held in banking book. The “philosophy” of banking book capital is to cover unexpected credit losses incurred over a one-year holding period. Exposures can be held in the trading book only if actively managed and held with “trading intent” (*e.g.*, to obtain trading or arbitrage profits). The “philosophy” of trading book capital is to cover losses in value during a very short period (*e.g.*, 10 to 20 days) prior to exiting an exposure.
- **Capital Requirements Consistent with Credit Risk**.

  Banking Book
  In the banking book, the general formula for calculating capital charges is:

  Capital charge = EA x RW x GCR

  Where:

  EA = amount of exposure

  RW = risk weight of exposure

  GCR = general capital requirement (8 percent under Basel II)

  For all banks, risk weights depend on the nature of the exposure (*e.g.*, claims on sovereigns, claims on financial institutions, claims on corporates, retail claims, claims secured by real estate, specialised lending exposures, equity exposures and securitisation exposures). For Standardized Banks, risk weights are then determined on the basis of the public rating of the exposure by a qualified rating agency. For IRB Banks, risk weights are then determined on the basis of risk characteristics relating to each exposure that constitute inputs into complex formulas. The risk characteristics for non-securitization exposures are the exposure’s “probability of default” (PD), the bank’s “exposure at default” (EAD), the bank’s “loss given default” (LGD) and the exposure’s “maturity” (M).

  An off-balance sheet commitments is multiplied by a “credit conversion factor” (CCF) to determine its on-balance sheet exposure amount prior to determining its capital charge.

Trading Book
In the trading book, banks determine capital pursuant to either (i) a standardised method which charges capital against specific risks and market risks, or (ii) supervisor-approved value-at-risk (VaR) models. In addition, a counterparty credit charge is assessed against all over-the-counter (OTC) derivative positions.

Summary of Reforms

Increased Capital Requirements

Under Basel III, both the quantum and the quality of required capital will increase substantially. Moreover, the new required capital ratios will be calculated after regulatory deductions and other adjustments rather than prior to such deductions under Basel II.

Capital levels will be increased as follows:

- **Core Tier 1 Capital**. The minimum requirement for Core Tier 1 capital will be more than doubled from 2 percent before deductions to 4.5 percent after deductions. Concurrently, the required level of total Tier 1 capital will increase from 4.0 percent to 6.0 percent. These increases will be phased in commencing January 1, 2013 and will be complete on January 1, 2015.
- **New 2.5 percent "capital conservation buffer."** In addition, banks must meet an incremental 2.5 percent capital requirement to be satisfied entirely by Tier 1 common equity. This new requirement will be phased in commencing January 1, 2016 and will be complete on January 1, 2019. If and as long as this capital buffer is not met, a bank may continue its normal banking operations but may not use a specified percentage of its earnings for (i) dividends, share buy-backs, other payments and distributions on Tier 1 capital instruments and (ii) discretionary bonuses. Thus, although the capital conservation buffer technically raises the total Tier 1 common equity requirement to 7 percent, in practice banks may well hold more than 7 percent Tier 1 common equity to avoid the risk of falling into the buffer zone.
- **New zero to 2.5 percent "countercyclical capital buffer"**. Finally, national supervisors are authorised to impose an additional capital requirement on banks to slow the growth of bank balance sheets during phases of excessive economic expansion. The requirement, set between zero and 2.5 percent, will be phased in commencing January 1, 2016 and will be complete on January 1, 2019. National authorities will set the buffer level by public announcement (increases generally to be subject to 12-month pre-announcement; decreases generally to be effective immediately). The countercyclical buffer must be met entirely by Tier 1 common equity, although the Committee is considering whether other fully loss-absorbing capital may qualify. The buffer is to apply to banks on the basis of the geographic composition of their credit exposures (based on the location of the obligor and not the booking jurisdiction). As with the capital conservation buffer, if and as long as the countercyclical capital buffer is not met a bank may continue its normal banking operations but may not use a specified percentage of its earnings for (i) dividends, share buy-backs, other payments and distributions on Tier 1 capital instruments and (ii) discretionary bonuses. The specified percentage required to be retained varies depending upon whether just the capital conservation buffer is in place or whether that buffer plus a countercyclical buffer are in place.

In addition, under Basel III, banks must determine available Tier 1 capital after (and no longer prior to) numerous material deductions, including goodwill and other intangibles; deferred tax assets; cashflow hedge reserves; shortfall of provisions to expected losses (for IRB banks only); gains on sale from securitisations; changes in own credit; defined benefit pension fund assets and liabilities; investments in own shares (treasury stock); reciprocal holdings in banking, financial and insurance entities (less than 10 percent); significant holdings in banking, financial and insurance entities (more than 10 percent); and additional "threshold" deductions (for mortgage servicing rights, certain deferred tax assets and certain investments (*i.e.*, more than 10 percent) in non-consolidated banking, insurance and financial entities). Moreover, each bank must publically disclose information about (i) the full terms and conditions of its regulatory capital instruments, (ii) its regulatory deductions and (iii) a reconciliation of its regulatory capital calculations to its audited balance sheet.

Finally, unrated securitization exposures, certain equity exposures, failed delivery-versus-payment transactions, and significant investments in commercial entities, are given a 1,250 percent risk weighting under Basel III (instead of a deduction of 50 percent from Tier 1 and 50 percent from Tier 2 under Basel II). Although this appears to be a technical change, any bank with more than an 8 percent capital ratio requirement must as a result hold more capital against these exposures than the amount of the exposure (*e.g.*, a bank with a 12 percent capital ratio requirement will hold 50 percent more capital against these exposures than the amount of the exposures, due to the change).

Implementation of the changes described above will occur on the following timetable (all dates as of January 1; shading indicates transition period):

	2011 (B II)	2012	2013	2014	2015	2016	2017	2018	2019 (B III)
Minimum Common Equity Capital Ratio	2.0%	2.0%	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer	0%	0%	0%	0%	0%	0.625%	1.25%	1.875%	2.5%
Minimum Common Equity plus Capital Conservation Buffer	2.0%	2.0%	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions	0%	0%	0%	20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	4.0%	4.0%	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%	8.0%	8.0%
Minimum Total Capital plus Capital Conservation Buffer	8.0%	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%

Redefining Qualifying Capital

Under Basel III, instruments qualifying for recognition as Tier 1 or Tier 2 capital will be restricted substantially and Tier 3 capital will be eliminated entirely. In order to qualify, new non-common equity Tier 1 and Tier 2 instruments must, among other features, (i) be more loss-absorbing, (ii) not contain incentives to redeem prior to their stated maturity. and (iii) be written off or converted to equity at the determination by the relevant supervisor either that the bank would not be viable without the write-off or that a public sector capital injection is to be made. These changes will render ineligible most if not all upper Tier 1 and Tier 2 instruments issued prior to the publication of Basel III. Most ineligible instruments (*e.g.*, innovative hybrid capital instruments with incentives to redeem), formerly limited to 15 percent of the Tier 1 capital base, will be phased out or even be fully derecognised commencing January 1, 2013.

Components of Capital

- **Common Equity Tier 1 Capital (CET 1)**. Common shares issued by the bank; stock surplus (share premium); retained earnings (including interim profit or loss); accumulated other comprehensive income and other disclosed reserves; and common shares issued by consolidated subsidiaries of the bank and held by third parties (*i.e.*, minority interests) that meet the criteria for CET 1 (subject to additional conditions); with regulatory deductions (see above) and dividends removed from CET 1.
- **Additional Tier 1 Capital (AT 1)**. Instruments meeting criteria for inclusion as AT 1 (for a description of the specific criteria, see the more detailed summary of Basel III here); stock surplus (share premium) resulting from instruments included in AT 1; and instruments issued by consolidated subsidiaries of the bank and held by third parties (*i.e.*, minority interests) that meet criteria for AT 1 (subject to additional conditions); with regulatory deductions (see above) removed from AT 1.
- **Tier 2 Capital (T 2)**. Instruments meeting criteria for inclusion as T 2 (for a description of the specific criteria, see the more detailed summary of Basel III here); stock surplus (share premium) resulting from instruments included in T 2; instruments issued by consolidated subsidiaries of the bank and held by third parties (*i.e.*, minority interests) that meet criteria for T 2 (subject to additional conditions); and certain loan loss provisions or reserves; with regulatory deductions (see above) removed from T 2.

Timing

- **Derecognition and Transition**. Non-qualifying CET 1 instruments will be fully derecognised from January 1, 2013 (with a limited exception for certain non-stock company equity). Non-qualifying AT 1 and T 2 instruments will be phased out (*i.e.*, not recognised as capital) in the amount of 10 percent each year, commencing on January 1, 2013 until fully phased out on January 1, 2023 (redemptions and amortisations of non-qualifying instruments after January 1, 2013 will not reduce the base for the phase-out calculation). Non-qualifying instruments issued after September 12, 2010 will be fully derecognised from January 1, 2013.
- **Exceptions for instruments with incentives to redeem**.
  - Instruments (i) with a call or step-up (or other incentive to redeem) occurring prior to January 1, 2013, (ii) that are not called or redeemed and (iii) that meet the relevant criteria on a forward-looking basis, will continue to be recognised in capital.
  - Instruments (i) with a call or step-up (or other incentive to redeem) occurring on or after January 1, 2013, (ii) that are not called or redeemed and (iii) that meet the relevant criteria on a forward-looking basis, will be phased out by 10 percent per year commencing January 1, 2013.

  - Instruments (i) with a call or step-up (or other incentive to redeem) occurring between September 12, 2010 and January 1, 2013, (ii) that are not called or redeemed and (iii) that do not meet the relevant criteria on forward-looking basis, will be fully derecognised on January 1, 2013.
  - Instruments (i) with a call or step-up (or other incentive to redeem) occurring on or after January 1, 2013, (ii) that are not called or redeemed and (iii) that do not meet the relevant criteria on a forward-looking basis, will be (a) until the effective maturity date of the instrument phased out by 10 percent per year commencing January 1, 2013, and (B) upon such effective maturity date fully derecognised.
  - Instruments (i) with a call or step-up (or other incentive to redeem) occurring on or prior to September 12, 2010, (ii) that are not called or redeemed and (iii) that do not meet the relevant criteria on forward-looking basis, will be phased out by 10 percent per year commencing January 1, 2013.
- **Public Sector Capital**. Existing public sector capital injections will be grandfathered until January 1, 2018.
- **European Union**. It should be noted that the modifications to the CRD that became effective on December 31, 2010 contained extensive changes to the definition of regulatory capital, as well as transitional arrangements for existing non-qualifying capital instruments. These provisions will need to be modified further in connection with the adoption of Basel III into the CRD and then into national law.
- **Dodd-Frank**. The "Collins Amendment" in Dodd-Frank imposes a similar phase-in of derecognition of certain capital instruments, although the exact rules and details regarding implementation have not yet been issued. Certain debt or equity instruments (*e.g.*, trust preferred securities and other hybrid instruments) issued on or after May 19, 2010 will no longer count towards a United States bank holding company's Tier 1 capital, starting with a 3-year phase in period beginning on January 1, 2013. These limitations do not apply to banking organizations with assets of less than $15 billion as of December 31, 2009, and there are other narrow exemptions as well.

Increased Capital Charges

Banking Book

Under Basel 2.5, the following changes became effective on December 31, 2010:

- **Re-securitisation Exposures**. Risk weights for "re-securitisation exposures" are approximately 200 percent higher than comparably rated non-resecuritisation exposures for Standardized Banks and approximately 300 percent higher than comparably rated non-resecuritisation exposures for IRB Banks. The actual size of the increase will depend on the rating of the exposure. A re-securitization exposure is defined as a securitization exposure where one or more underlying exposures is securitization exposure. A securitisation exposure is defined as an exposure where cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk.
- **Liquidity Facilities**. For Standardized Banks, the distinction between eligible liquidity with an original maturity of one year or less (currently credit conversion factor (CCF) of 20 percent) and those with an original maturity of more than one year (currently CCF of 50 percent) will be abolished. Instead, a 50 percent CCF will apply to all eligible liquidity facilities provided by Standardized Banks. For IRB Banks, several technical adjustments have been made to clarify the circumstances under which liquidity may be treated as the most senior exposure in a securitisation transaction (thereby resulting in lower capital charges). Finally, reduced credit conversion factors for disruption-only liquidity have been eliminated.

- **Use of ratings subject to self-guarantee**. Banks are no longer permitted to recognise internal ratings based on unfunded guarantees or similar support provided by the bank itself. Accordingly, if an ABCP conduit sponsor provides liquidity or credit enhancement to its conduit, but then buys the ABCP instead of funding its liquidity commitment or credit enhancement, it must treat the ABCP as unrated. It may use the internal assessments approach (IAA) if authorised, or the supervisory formula approach (SFA) (although the SFA may not work well with ABCP conduits for some technical reasons), but if it is unable to use either the IAA or the SFA the exposure must be deducted from capital despite its creditworthiness.

Trading Book

- **Counterparty Credit Risk**. Under Basel III, with effect from January 1, 2013, counterparty credit risk capital charges will be increased in numerous ways, including (but not limited to):
  - Default Risk. To address "wrong way" risk (*i.e.*, where a bank's exposure to a counterparty increases as the counterparty's creditworthiness decreases), the default risk capital charge for counterparty credit risk must equal the greater of the portfolio-level capital charge (not including the CVA charge described below) based on "Effective EPE" (Effective Expected Positive Exposure) using current market data and the portfolio-level capital charge based on Effective EPE using stressed data.
  - CVA Risk Charge. In addition to the default risk charge, banks must add a capital charge to cover the risk of mark-to-market losses on expected counterparty risk (referred to as "credit value adjustments", or CVA) for all OTC derivatives (but not transactions with central counterparties or securities financing transactions). The CVA charge is determined pursuant to a formula, dependant upon whether the bank has internal VaR model approval or uses the standardised method for determining trading book capital.
- Asset Value Correlation (AVC) Multiplier. For all exposures to financial institutions held by IRB banks, the bank holding the exposure will be required to determine PD and LGD using a 1.25 multiplier for (i) all regulated financial institutions whose total assets are equal to or greater than US$100 million and (ii) all unregulated financial institutions regardless of size. For this purpose, unregulated financial institutions are legal entities whose main business includes management of financial assets, lending, factoring, leasing, provision of credit enhancement, securitisation, investments, financial custody, central counterparty services, proprietary trading and other activities identified by supervisors.
- Greater Margin Period of Risk. The risk period to be covered by trading book capital will be doubled to 20 days for OTC derivatives and securities financing transactions (SFTs) (i) with more than 5,000 trades subject to netting between the same counterparties (netting sets), (ii) with illiquid collateral, or (iii) representing hard-to-replace derivatives. In addition, the risk margin period will be doubled for OTC derivatives and securities financing transactions if more than two call disputes lasting longer than the margin risk period occur between the same two counterparties during the preceding two quarters.
- Downgrade Triggers Prohibited. Banks using internal models may not adjust their exposure at default (EAD) for any counterparty if the collateral agreement with that counterparty requires more collateral to be posted in the event of a downgrade in such counterparty's credit rating.
- Additional Haircuts for Securitization Collateral. Re-securitization exposures are

no longer eligible as financial collateral. In addition, haircuts applicable to non-sovereign exposures are doubled for securitization exposures compared with non-securitization corporate exposures at the same rating level.
    - Central Clearing Parties. The Committee has issued for comment (for finalization in 2011) incentives to use Central Clearing Parties (CCPs) for OTC derivatives. The Committee has proposed that collateral and mark-to-market exposures to CCPs should have risk weight of 2 percent if the CCP (i) complies with certain recommendations of the Committee for Payment Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) for CCPs and (ii) satisfies certain other conditions.
- **Internal Models**. Under Basel 2.5, with effect from December 31, 2010, banks which are authorized to determine trading book capital pursuant to internal value-at-risk models will be required to revise their models to cover a "stressed value-at-risk" measure, modelling stress on the basis of crises such as the 1987 equity crash, the crises in 1992 and 1993 in the European Exchange Rate Mechanism (ERM), the fall in bond markets in Q1 1994, the 1998 Russian financial crisis, the 2000 technology bubble burst and the 2007/2008 sub-prime turbulence. In addition, bank models must be expanded to cover incremental default and migration risks. The existing supervisory add-on under Basel II (*i.e.*, an incremental capital charge of between zero and 1.0 percent depending upon the backtesting of the bank's model) will continue to be based on the bank's value-at-risk model only and not on its stressed value-at-risk model.
- **Correlation Trading Portfolio**. Some banks operate so-called correlation trading portfolios pursuant to which they permit sophisticated investors to acquire synthetic exposure, often leveraged, to various corporate and other credits held by the banks in their trading portfolios. Under Basel 2.5, with effect from December 31, 2010, banks will be expressly prohibited from holding in their correlation trading portfolios exposures such as retail exposures, residential mortgage exposures, commercial mortgage exposures, re-securitisation exposures, options on a securitisation tranche, and synthetically leveraged super-senior tranches. The specific risk capital charge for the correlation trading portfolio will be revised to equal the greater of (i) the total specific risk capital charges applying just to net long positions from net long correlation trading exposures combined and (ii) the total specific risk capital charges applying just to net short positions from the net short correlation trading exposures combined. Alternatively, banks may adopt a "comprehensive risk measure" for determining capital for the correlation trading portfolio.
- **Securitisation**. Under Basel 2.5, with effect from December 31, 2010, the specific risk capital charge for securitisation exposures held in the trading book will be increased to equal the same charge as if such exposures were held in the banking book. A capital charge will be applied to the bank's net position whether long or short. IRB Banks will be permitted to use the SFA for securitisation positions in the trading book with supervisor approval.
- **Nth-to-Default Derivatives**. Under Basel 2.5, with effect from December 31, 2010, capital charges for first-to-default and nth-to-default derivatives will increase substantially. The capital charge for specific risk for a first-to-default credit derivative will be the lesser of (i) the sum of the specific risk capital charges for individual reference credit instruments in basket, and (ii) the maximum possible credit event payment under the contract. The capital charge for specific risk for nth-to-default credit derivatives with "n" greater than 1 will be the lesser of (a) the sum of the specific risk capital charges for individual reference credit instruments in the basket but disregarding n-1 obligations with the

lowest specific risk capital charges and (b) the maximum possible credit event payment under contract. For nth-to-default credit derivatives with n greater than 1, no offset of the capital charge for specific risk with any underlying reference credit instrument will be allowed.

Leverage Ratio

A new leverage ratio based on gross exposures will be adopted as a non-risk weighted "backstop" measure (supplementary to the risk-weighted capital ratio described above) to constrain the build-up of excessive leverage in banks. A ratio of 3 percent (*i.e.*, 33 times maximum leverage), calculated as an average over each fiscal quarter, will be tested during a parallel run period from January 1, 2013 to January 1, 2017 and adopted in full on January 1, 2018.

- **Capital Base**. The bank's capital base for the leverage ratio will equal its Tier 1 capital only (*i.e.*, CET 1 and AT 1), measured after all regulatory deductions described above. The Committee will collect data during the parallel run and will consider whether it would be preferable to use only CET 1 or all capital for the capital base. Assets of financial entities in which the bank holds minority investments will be deducted in proportion to the capital excluded.
- **Exposure Values**. The bank's aggregate gross exposure value will generally follow its accounting treatment of on-balance sheet, non-derivative exposures, which will be measured net only of provisions and valuation adjustments. Physical or financial collateral, guarantees or credit risk mitigation will not be allowed to reduce exposure, and netting of loans and deposits will not be allowed. For derivatives, the accounting measure of exposure will be used (as above) *plus* an add-on for future exposure (under the Basel II CEM method), applying Basel II netting rules other than cross-product netting. For off-balance sheet items, subject to further Committee review, a 100 percent credit conversion factor will be used, other than a 10 percent conversion factor for unconditionally cancellable commitments. Off-balance sheet items subject to the 100 percent CCF will include commitments (including liquidity commitments), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities (but not repurchase agreements and securities finance transactions).

Liquidity Ratios

- **Liquidity Coverage Ratio (LCR)**. The new LCR requires banks to maintain unencumbered high-quality assets sufficient to meet at least 100 percent of net cash outflows over a 30-day period under a stipulated stress scenario.
  - Stress Scenario. The stipulated stress scenario includes a stipulated run-off of a proportion of retail deposits, a stipulated partial (or in some cases total) loss of unsecured wholesale funding capacity, a stipulated partial loss of secured short-term funding with certain collateral and counterparties, additional contractual outflows arising from a presumed downgrade in the bank's public credit rating of up to and including three notches, additional collateral posting requirements under derivatives, unscheduled draws on committed but unused credit and liquidity facilities, and (interestingly) a stipulated buy back of debt or honouring of non-contractual obligations to mitigate reputational risk.
  - Liquid Assets. Against this cash outflow (net of certain presumed in-flows), a bank must hold liquid assets exhibiting characteristics such as low credit and market risk, low market concentration, ease and certainty of valuation, low correlation with risky assets, listed on a developed and recognised exchange market, and traded in an active and sizeable market in which committed market makers

operate. Liquid assets are divided into two "levels", with Level 1 consisting of cash, central bank reserves (to the extent that they can be drawn down in times of stress), marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities (PSEs), the Bank for International Settlements, the International Monetary Fund, the European Commission or multilateral development banks subject to certain conditions. Level 2 assets, which are subject to cap of 40 percent of all liquid assets and are subject to 15 percent haircut against their notional amount, include (subject to certain conditions) marketable securities representing claims on or guaranteed by sovereigns, central banks, non-central government PSEs and corporate and covered bonds.

- **Net Stable Funding Ratio (NSFR)**. The purpose of the NSFR is to establish a minimum acceptable amount of stable funding based on liquidity characteristics of a bank's assets and activities over a one-year horizon, in order to incentivise structural changes in a bank's liquidity risk profile away from short-term funding mismatches and towards more stable, longer-term funding of assets and business activities. To that end, a bank's "Available Stable Funding" must equal or exceed its "Required Stable Funding."
  - Available Stable Funding equals a bank's stock of regulatory capital (both Tier 1 and Tier 2), after deductions, together with certain additional assets subject to haircuts. Available stable funding will also include preferred stock not included in Tier 2 if it has an effective remaining maturity of one year or greater. Liabilities with effective remaining maturities of one year or greater will be included subject to various "ASF Factors" (*i.e.*, haircuts) depending upon their type. For example, "stable" non-maturity deposits and/or term deposits with maturities of less than one year provided by retail and small business customers will have an ASF Factor of 90 percent (*i.e.*, a 10 percent haircut).
  - Required Stable Funding will equal the sum of (i) assets held by bank and off-balance sheet commitments of the bank (ii) multiplied by the relevant required stable funding factor (RSF). For example, unencumbered cash and money market instruments; unencumbered securities with effective remaining maturities of less than one year; unencumbered securities where the bank has an offsetting reverse repo with the same CUSIP or ISIN; unencumbered loans to financial institutions that are not renewable or for which lender has an irrevocable call right, all will have a 0 percent RSF (meaning that they do not form part of a bank's Required Stable Funding). In contrast, unencumbered loans to retail and small business customers with residual maturity of less than one year will have an 85 percent RSF and all balance sheet items not otherwise assigned an RSF will have a 100 percent RSF. For off-balance sheet exposures, conditionally revocable and irrevocable credit and liquidity facilities to any client will have a 5 percent RSF Factor, and all other contingent funding obligations (includes guarantees, letters of credit, other trade instruments; non-contractual obligations, etc.) will have RSF Factors assigned by the relevant national supervisor.

On-going Work

In addition to the work described above, the Committee is undertaking additional work that might result in further changes to the Basel Accord within the next few years:

- **Systemically Important Banks**. The Committee will develop a provisional methodology for assessing the systemic importance of financial institutions globally, and will complete

by mid-2011 a study of the magnitude of additional loss absorbency that globally systemically important banks should have. In the US, Dodd-Frank empowers a new Financial Stability Oversight Council to designate systemically significant banks and non-bank financial institutions and imposes enhanced capital, liquidity and other requirements on them. Whether and how the Committee methodology and the Dodd-Frank approach will be harmonized remains to be seen.
- **Fundamental Review of Trading Book**. The Committee is studying whether the distinction between the banking book and the trading book should be maintained, how trading activities are defined and how risks in trading books (and possibly market risk more generally) should be captured by regulatory capital. This review is targeted for completion by year-end 2011.
- **Ratings and Securitisations**. The Committee is working to reduce reliance on external ratings in rules and regulations for securitisation exposures.
- **Contingent Capital**. The Committee will complete by mid-2011 an assessment of the going-concern loss absorbency which could be provided by various proposed contingent capital instruments.
- **Reducing Pro-Cyclicality**. The Committee is reviewing additional measures to reduce pro-cyclicality, including by using the Pillar 2 process to provide non-cyclical or through-the-cycle PD determinations and by promoting stronger provisioning by moving entirely to an expected loss provisioning approach under applicable accounting standards.
- **Large Exposures**. The Committee is reviewing large exposure rules across various jurisdictions to strengthen guidance in this area.
- **Cross-Border Bank Resolution**. The Committee is working on cross-border bank resolution issues, building on its 2010 Report and Recommendations of the Cross-Border Bank Resolution Group.
- **Review of Core Principles for Effective Banking Supervision**. The Committee is revising its 2006 Core Principles for Effective Banking Supervision and Core Principles Methodology.
- **Standards Implementation**. The Committee, through its Standards Implementation Group, has issued a Standards Surveillance Framework that will be piloted in 2011.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

C. Mark Nicolaides
+44.20.7710.1100
mark.nicolaides@lw.com
London

Uwe Eyles
+49.69.6062.6503
uwe.eyles@lw.com
Frankfurt

Ellen Marks
+1.312.876.7626
ellen.marks@lw.com
Chicago

Brian Smith
+1.202.637.2288
brian.smith@lw.com
Washington DC

Angela Angelovska-Wilson
+1.202.637.2398
angela.angelovska-wilson@lw.com
Washington DC

Melissa Hall
+1.202.637.2292
melissa.hall@lw.com
Washington DC

Abu Dhabi	**Houston**	**Paris**
Barcelona	**London**	**Riyadh***
Beijing	**Los Angeles**	**Rome**
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