STANDARD & POOR'S

Global Credit Portal
RatingsDirect®

March 4, 2010

Basel III For Global Banks: Third Time's The Charm?

Primary Credit Analyst:
Richard Barnes, London (44) 20-7176-7227; richard_barnes@standardandpoors.com

Secondary Credit Analysts:
Arnaud De Toytot, Paris (33) 1-4420-6692; arnaud_detoytot@standardandpoors.com
Scott Sprinzen, New York (1) 212-438-7812; scott_sprinzen@standardandpoors.com
Terry Chan, Melbourne (61) 3-9631-2174; terry_chan@standardandpoors.com

Table Of Contents

Overview Of The Basel III Capital Proposals

Overview Of The Basel III Liquidity Proposals

Transparency

Next Steps

Related Research

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page.

790087 | 300000294

Basel III For Global Banks: Third Time's The Charm?

In December 2009, the Basel Committee on Banking Supervision published two consultative documents which set out proposals to strengthen the capitalization and liquidity of the global banking sector. The proposals have been widely dubbed "Basel III" because they would be the third edition of the minimum standards applied by regulators to internationally active banks.

The consultative documents are a response to the significant pressure exerted on banks' balance sheets by the extremely testing economic and market conditions of the past three years. In Standard & Poor's Ratings Services' view, the severe stress experienced by the global banking industry during this period has empowered the regulatory community to propose more stringent requirements than it has previously felt able to apply. If their final form is reasonably close to the consultative version, the Basel III proposals are likely to extend the scope of the balance sheet strengthening measures already initiated by many banks, and potentially trigger fundamental changes in business models and product pricing. In this sense, they could mark one of the most significant developments in banking regulation since the original Basel Accord was introduced in 1988. We anticipate a prolonged transition period and significant grandfathering arrangements to cushion the immediate impact of Basel III implementation on the banking system and, by extension, the real economy.

Standard & Poor's is broadly supportive of the Basel III proposals. In general, we consider that they are a sensible response to shortcomings in the current regulatory approach that were highlighted by the recent downturn. We see the essence of the capital proposals as being consistent with our in-house analytical tools, such as our risk-adjusted capital framework (RACF). We developed the RACF and our own definitions of bank capital because we consider that the value of existing regulatory ratios is undermined by methodological weaknesses and by inconsistencies in application by national regulators. While Basel III has the potential to address some of these issues, the comparability of regulatory ratios would still be blurred by differences between banks' internal rating models and by the availability of various options to assess identical risks. Equally, we do not expect Basel III to resolve all of the differences in approach between national regulators. We note that the U.S., for example, has been slower than other major countries in its implementation of Basel 2, and we consider that similar variations are likely under Basel III. The European Commission has recently launched a consultation process on the legislative changes required to implement capital and liquidity reforms in the European Union, and we note that its proposals are closely aligned with those of the Basel Committee.

The Basel III liquidity proposals represent the first attempt by international regulators to introduce harmonized minimum standards, which is a long overdue development in our view. Some national regulators have already overhauled their liquidity regimes in light of recent events, and the Basel III proposals appear to build on the best practices in these approaches.

We view positively the strong improvement in transparency and the emphasis placed on market discipline in the various elements of the Basel III proposals. To date, we believe the disclosure provided by banks regarding regulatory capital measures has frequently been deficient.

We are currently reviewing the detail of the Basel III consultative documents, and we intend to publish more extensive analysis of them before the comment period ends on April 16, 2010. At this early stage, we do not expect

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

that Basel III, once implemented, would likely have a material impact on our bank ratings, which are partly predicated on capitalization being strengthened before governments reduce their support of the banking system. We will, of course, revisit this conclusion as the Basel III proposals move closer to their final form. Over time, the Basel III regime might have a positive influence on our bank ratings, at least the stand-alone credit profiles, if it contributes to greater resilience to future shocks and the industry is able to transition smoothly to the strengthened capital and liquidity requirements.

The Basel III proposals are unlikely to be the last word on reforms of the banking industry following the credit crunch. While there appears to be international agreement that the banking industry must maintain stronger capital and liquidity reserves, we do not observe a broad consensus among governments and regulators about the need for, or design of, structural changes. The Basel III consultative documents raise the prospect of capital and liquidity surcharges for systemically important institutions, and the proposals on counterparty credit risk are partly intended to address the "interconnectedness" of the financial system. The Basel Committee intends these initiatives to contribute to the wider debate on the risks of systemically important banks. Discussions on such structural issues appear likely to continue for some time.

Overview Of The Basel III Capital Proposals

The paragraphs below summarize what we see as the key components of the proposals for enhancing the regulatory capital framework. The consultative document is divided into four broad themes:

1. Improving the quality and consistency of regulatory capital

A primary goal of the Basel Committee is to increase the quality and global consistency of regulatory capital and to standardize the required deductions and adjustments. It intends that Tier 1 capital should enable each bank to remain a going concern, with Tier 2 capital recategorized as a "gone concern" reserve to protect depositors in the event of insolvency, and Tier 3 capital abolished altogether. In addition, it states that Tier 1 capital should predominantly comprise common equity and retained earnings, with a tighter definition of common equity. The Basel Committee proposes the introduction of much stricter criteria on the inclusion of hybrid instruments, notably the requirement for coupons to be noncumulative and fully discretionary and for principal to be available to absorb losses on an ongoing basis, either through principal writedown or conversion into common equity. This stance accords with our recent criteria refinement, which highlighted that we will give only minimal equity content in our Adjusted Total Equity (ATE) and Total Adjusted Capital (TAC) capital measures to certain types of hybrids that do not provide sufficient flexibility to defer coupons (see "Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments," published Feb. 9, 2010 on RatingsDirect). The Basel III proposals are likely to make hybrid Tier 1 capital more equity-like and homogeneous, with a higher likelihood of coupons on future hybrids being cancelled in periods of stress. Furthermore, the Basel Committee proposes to phase out so-called innovative Tier 1 instruments with embedded incentives to redeem, such as coupon step-ups. Overall, investors in hybrids eligible within future Tier 1 capital are expected to bear more risks, both in terms of loss absorption and the potential absence of redemption. As stated in our criteria, heightened risk of nonpayment or deferral leads us to assign lower ratings to hybrid issues. We would therefore adjust our hybrid ratings to take account of regulatory changes that make such instruments more likely to absorb losses.

We welcome the proposal to strengthen and simplify the capital structure of banks. Recent experience has shown us

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

that the co-existence of multiple classes of regulatory capital instruments has sometimes had unintended consequences in terms of the flexibility to defer coupons and the predictability of banks' behavior. Furthermore, some regulatory capital instruments such as nondeferrable Tier 2 and Tier 3 issues had minimal equity content, and therefore we have not included them in our capital measures.

The consultative document lists a number of items that must be adjusted for in common equity, including minority interests in consolidated subsidiaries, unrealized losses on balance sheet assets, cashflow hedge reserves, goodwill and other intangibles, net tax loss carryforwards, defined-benefit pension fund deficits, investments in unconsolidated subsidiaries such as insurance businesses, and any shortfall in loan loss provisions relative to expected losses. The proposals also call for improved disclosure of regulatory capital calculations to enhance transparency and aid reconciliations with accounting data.

These proposals represent a significant tightening and harmonization of regulatory capital requirements. It appears, for example, that few existing Tier 1 hybrid instruments would qualify for continued inclusion in Tier 1, absent a grandfathering arrangement. In addition, the list of capital adjustments is more comprehensive than the rules currently applied of any major national regulator. The proposal that these items should be deducted from common equity rather than a broader capital measure is very exacting. However, it addresses one of the weaknesses of the current regime, where capital needs of certain activities, particularly nonbanking businesses such as insurance, were partly or entirely covered by subordinated debt which did not absorb losses on a going-concern basis. Given the complexity of capital requirements for financial conglomerates, it remains to be seen if this more demanding rule will be implemented in a consistent manner in all jurisdictions. We believe the required Basel III deductions would likely have a significant impact on most banks, with certain institutions and sectors particularly affected. For example, the requirement to fully deduct pension fund deficits mirrors our existing approach, but would be much tougher than the regulatory adjustment currently applied in the U.K., where banks' employee pension schemes tend to be relatively large.

In the RACF, we already reflect most, but not all, of the proposed Basel III capital deductions either in the calculation of ATE and TAC or in one-for-one capital charges in Standard & Poor's risk-weighted assets. A notable difference in our approach relates to minority interests in consolidated subsidiaries, which we would deduct only if the subsidiary were a nonfinancial entity such as a property or industrial company or a special purpose vehicle. We regard the Basel III proposal to deduct all minority interests as asymmetric and overly conservative. Other differences relate, for instance, to the deduction of any shortfall in loan loss provisions relative to expected losses, or to the deduction of a number of equity stakes such as industrial holdings over a particular threshold. Although we would welcome more stringent and consistent deduction requirements, we consider that some of the proposed changes in regulatory deductions (for items such as tax loss carryforwards or unrealized losses) would likely exacerbate procyclicality, which is already a problem under the current Basel 2 regime. We note that the Basel III proposals advocate capital buffers to address this (see below for details).

The full consequences of these definitional changes cannot be accurately quantified until the Basel Committee has determined the minimum capital ratios that banks must maintain. It is undertaking an impact study during the first half of 2010 to calibrate the required minima, which would be applied at three different levels (common equity, Tier 1, and total regulatory capital). Since the effect of the Basel III proposals is likely to be material, we expect an extended transition period, significant grandfathering of existing capital instruments, and/or other regulatory adjustments to ease the impact on the sector and the wider economy. Still, the banking industry might well need to conserve capital--through constrained dividends, for example--and some institutions might decide to adapt their

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

business models--through selected disposals, for example--in response to the new rules.

2. Increased capital requirements on certain counterparty credit risks

To augment previously-announced increases in market risk capital charges which take effect at year-end 2010, the Basel III proposals contain a number of measures that would significantly raise capital requirements for trading-related counterparty risks. These changes are intended to address deficiencies in the Basel 2 methodology that were highlighted by the recent period of acute market volatility. In summary, the proposals in the Basel III consultative document call for: the use of stressed inputs in the calculation of potential future counterparty exposures; the introduction of a capital charge against potential mark-to-market losses arising from deteriorating counterparty creditworthiness short of actual default; an increase in the correlation assumptions for exposures to other financial institutions, with embedded incentives to move over-the-counter (OTC) trading to central counterparties and exchanges; and increased capital charges in certain other areas, such as wrong way risk (which arises when the probability of default and the exposure at default are positively correlated, as banks experienced, for example, in the case of asset-backed securities hedged with monolines).

Clearly, the proposed strengthening of the counterparty risk capital charge would have the greatest impact on banks with large capital markets activities. Our preliminary estimate is that the counterparty risk charge could increase very significantly from the current level, with the main driver being the proposed introduction of a Pillar 1 value-at-risk charge on counterparty valuation adjustments. In general, we consider that the proposed changes are a reasonable response to recent events. For example, our own assessment of asset correlation between financial institutions had indicated that the levels assumed in Basel 2 (12%-24%) were too low in times of stress. The potential implications for the smooth functioning of the interbank market require further consideration, however. Although we agree with the underlying concepts, we see calibration issues with the Pillar 1 value-at-risk charge on credit valuation adjustments, and believe that this should be reviewed in the Basel Committee's impact study.

3. Introduction of a leverage ratio

Leverage ratios are already applied to banks in certain countries, such as the U.S., and other national regulators, such as Switzerland's FINMA, have announced plans to introduce similar measures as a response to the recent crisis. The Basel III proposals would, if implemented, introduce a consistent leverage ratio measure for all internationally active banks. The consultative document indicates that this measure would initially be a Pillar 2 monitoring tool, but could ultimately become a Pillar 1 requirement. The document sets out a number of options for the calculation of the numerator and denominator of the ratio. Both are positioned relatively conservatively in our opinion. The numerator is intended to be a high quality capital measure, which suggests that it will be either common equity or Tier 1. For the denominator, the consultative document indicates that netting of repurchase agreement (repo) and derivative contracts might not be recognized. For many banks, this would make a substantial difference to the leverage ratio outcome, similar to the existing balance sheet gross-up under International Financial Reporting Standards (IFRS) relative to U.S. generally accepted accounting principles (GAAP). The Basel Committee will also consider whether to include short credit derivative positions and several off-balance-sheet items at their notional values, which would also have a significant impact in many cases.

In our view, since excessive leverage was evidently a contributory factor to the stress experienced by the banking sector since 2007, the introduction of a consistent leverage ratio measure could usefully complement risk-adjusted regulatory capital metrics and help to identify outliers. In our view, the effectiveness of the Basel III proposal will crucially depend on the final definition of the leverage ratio. If poorly calibrated, it could lead to outcomes that might be seen as undesirable from a broader perspective, such as a reduction in liquidity in the repo market as banks

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

reduce their portfolios to manage the leverage ratio calculation. The introduction of a measure of adjusted assets that eliminates inconsistencies between accounting standards would facilitate cross-regional comparisons, even beyond its particular use in a leverage ratio. However, an excessively wide definition of adjusted "gross" assets could make such information less relevant and potentially misleading.

4. Addressing procyclicality

Perhaps the most innovative section of the consultative document is the proposals to address procyclicality. We have consistently highlighted the procyclicality bias of Basel 2, and we consider that, without countervailing measures, this problem would likely be exacerbated by the Basel III proposals regarding the definition of capital. We sought to mitigate procyclicality in our RACF methodology by calibrating the capital charges to stress scenarios. The Basel Committee intends to evaluate a number of options to address procyclicality, including: the use of a noncyclical probability of default proxy in internal rating models; encouragement for provisioning policies to move to a forward-looking expected loss methodology rather than the incurred loss approach currently applied under IFRS and U.S. GAAP; and the introduction of capital buffers that would be proactively adjusted to take account of macroeconomic factors. The most ground-breaking proposal in our view is a mechanistic framework that would require the conservation of Tier 1 capital via restrictions on dividends, share buybacks, and discretionary bonuses if a bank's capitalization falls within specified ranges above its minimum regulatory requirement.

These proposals to address procyclicality sit alongside other macroprudential tools currently under consideration by regulators and governments. Their collective aim is to address potentially detrimental trends such as rising leverage, lending growth, and liquidity mismatches before they become excessive. Some regulators already have the power to adjust minimum capital requirements and require changes in underwriting criteria, but their track records in applying these powers have been mixed, partly we believe because they appeared reluctant to penalize their domestic banks relative to international competitors. The recent stress experienced by the banking sector has strengthened regulators' resolve, but time will tell whether this is maintained in the long term.

The proposed capital conservation framework is an interesting idea in our view, but requires detailed calibration, as the consultative document itself points out. The framework has been designed to address the collective action problem that may have occurred in the banking sector in the run-up to the crisis, when some institutions may have considered reducing distributions to staff and/or shareholders, but ultimately decided against such a move due to concerns that competitors would not follow suit. Depending on the calibration, the practical result of the framework might be that the regulatory capitalization targeted by banks is the level at which they have complete discretion over bonus and dividend payments.

The capital conservation framework is additionally aimed at assigning a more predictable loss absorption role to hybrid Tier 1 capital instruments on a going-concern basis and changing the market perception of the relative likelihood of nonpayment. As stated in our criteria, heightened risk of nonpayment or deferral leads us to assign lower ratings to hybrid issues, and we would therefore adjust these ratings to take account of regulatory changes that made such instruments more likely to absorb losses.

Overview Of The Basel III Liquidity Proposals

The Basel Committee published a separate consultative document in December 2009 regarding new international standards for liquidity management and monitoring. Specifically, the document proposes two complementary metrics that are intended to encapsulate banks' short-term liquidity and structural funding positions:

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

- The short-term liquidity metric--named the liquidity coverage ratio in the consultative document--would require banks to maintain high quality, unencumbered assets in excess of their stressed cash outflows over a 30-day time horizon. The document proposes several possible definitions of the numerator and denominator, including the haircuts to be applied to eligible liquid assets and the stressed outflow assumptions for each category of liabilities and off-balance-sheet commitments.
- The structural funding metric--named the net stable funding ratio--effectively assesses the behavioral maturity of each side of the balance sheet over a one-year horizon. More particularly, haircuts are applied to each category of assets and liabilities according to their expected stability through a stress scenario, and the available stable funding must exceed the required stable funding.

We regard the proposed introduction of internationally-consistent minimum liquidity standards as a positive step. We view the time horizon assumed in each ratio as relatively short, however, particularly for more highly rated institutions, which we would expect to target a longer survival period. The 30-day horizon used in the liquidity coverage ratio appears to have been borrowed from the established stress test standard for U.S. broker dealers. Although we believe this ratio would provide a better basis to compare banks than existing published liquidity metrics, the prolonged liquidity crunch of late 2008 and early 2009 demonstrates that financial institutions need to be able to function in a stress scenario for longer than 30 days. The consultative document proposes other monitoring tools to assess liquidity over different time horizons, but it is unclear whether these would be applied as consistently as the liquidity coverage ratio. We also consider that the categories put forward in the consultative document for banks' liquidity sources and uses have not yet been precisely defined, and could usefully be more granular and nuanced. The chosen definition of liquid assets could lead to distortions in the markets for eligible and non-eligible securities.

The consultative document does not make firm recommendations on important practical aspects of the proposed liquidity regime, such as the frequency of calculation, the depth of public disclosure, and the scope of application. For example, the document indicates that banks would report only on a consolidated basis, which might not be sufficient for large, global banks with major liquidity requirements in multiple currencies and regions. Although we would not advocate a regulatory regime which required banks to lock up material liquidity pools in individual jurisdictions, thereby constraining the fungibility of resources across each group, we believe that banks should demonstrate that they can channel funds to individual legal entities on a timely basis.

Transparency

We view positively the strong improvement in transparency and the emphasis placed on market discipline in the various elements of the Basel III proposals. We agree with the Basel Committee's view that the disclosure provided by banks regarding regulatory capital measures has frequently been deficient to date. The proposals would notably require a published reconciliation of regulatory capital measures to the financial statements, the separate disclosure of all regulatory adjustments, the identification of all limits applied, and the description of the main features of hybrid capital instruments. The committee intends to require rigorous Pillar 3 disclosures on other components of the proposals, such as the computation of the leverage ratio. Given the differences in accounting treatments across jurisdictions, for instance between IFRS and U.S. GAAP, Standard & Poor's is supportive of these additional disclosures that would facilitate comparison of financial metrics between jurisdictions.

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

Next Steps

We intend to review the Basel III consultative documents in further detail and publish more extensive analysis of them before the comment period ends on April 16, 2010. The Basel Committee plans to publish the final rules by year-end 2010, with implementation scheduled for year-end 2012. As stated earlier, we expect an extended transition period with significant grandfathering arrangements to manage the risk that the global economic recovery could be jeopardized if banks are forced to focus on balance sheet strengthening at the expense of their core functions.

Related Research

- Assumptions: Implications Of The December 2009 Basel III Proposals For Our Bank Hybrid Criteria, Feb. 9, 2010
- Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010
- Methodology And Assumptions: Risk-Adjusted Capital Framework For Financial Institutions, April 21, 2009
- Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data, April 26, 2007

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com

Standard & Poor's. All rights reserved. No reprint or dissemination without S&P's permission. See Terms of Use/Disclaimer on the last page. 790087 | 300000294

Copyright © 2010 by Standard & Poors Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved. No part of this information may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written permission of S&P. S&P, its affiliates, and/or their thirdparty providers have exclusive proprietary rights in the information, including ratings, creditrelated analyses and data, provided herein. This information shall not be used for any unlawful or unauthorized purposes. Neither S&P, nor its affiliates, nor their third-party providers guarantee the accuracy, completeness, timeliness or availability of any information. S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents are not responsible for any errors or omissions, regardless of the cause,or for the results obtained from the use of such information. S&P, ITS AFFILIATES AND THEIR THIRD-PARTY PROVIDERS DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents be liable to any party for any direct, indirect, incidental,exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the information contained herein even if advised of the possibility of such damages.

The ratings and credit-related analyses of S&P and its affiliates and the observations contained herein are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or make any investment decisions. S&P assumes no obligation to update any information following publication. Users of the information contained herein should not rely on any of it in making any investment decision. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of each of these activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P's Ratings Services business may receive compensation for its ratings and credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge) and www. ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.7280 or by e-mail to: research_request@standardandpoors.com.

Copyright © 1994-{0} by Standard & Poor's Financial Services LLC, a subsidiary of The McGraw-Hill Companies, Inc. All Rights Reserved.

The McGraw·Hill Companies