Basel III and IFRS 9

A tightening of the regulations

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During the second half of 2010, both the Basel Committee on Banking Supervision and the International Accounting Standards Board provided further clarification and quantification of the required global standards for capital, liquidity and for the accounting of financial instruments. In this briefing we summarise these new regulations and examine their impact

Back in 2009, in response to the financial crisis, the Basel Committee on Banking Supervision (BCBS) published two papers that set out major revisions and enhancements to the Basel II framework. These were followed in December 2009 by two consultation papers on capital and liquidity. In July 2010, following lobbying from the financial sector and a parallel impact study, high-level changes to the BCBS 2009 papers were agreed. In addition, the BCBS published a further consultative paper that laid out its proposal for a counter-cyclical capital buffer. These consultation papers were the foundation of what is now referred to as 'Basel III'. In September 2010, the Group of Governors and Heads of Supervision – the oversight body for the BCBS – announced how the minimal capital requirements would be set and these were subsequently ratified by the Group of 20 in November 2010. In December 2010, the BCBS published finalised papers on both capital and liquidity, for implementation between 2013 and 2019.

While the December 2009 proposals created major challenges and uncertainty about the impact of Basel III, the new papers and announcements provide much-needed clarification. In essence, they address and mitigate some of the most contentious issues that were raised in the 2009 documents. They provide more detail in areas that were previously flagged up for increased regulation, offering formal guidance on proposed standards and how to apply them in practice. Key areas include a modified definition of capital, the introduction of a leverage ratio and counter-cyclical capital buffer, and the implementation of a global liquidity requirement. While implementation dates vary according to the specific regulatory areas, consensus is that the deadlines are demanding. The drafting and phasing-in of IFRS 9 also continues to move forward and, in this article, we examine the latest developments and their impact.

Basel III – Looking ahead

The uncertainties and worst-case projections about the impact of Basel III have been replaced by clarity and acceptance. However, now the hard work must begin for banks – applying the standards right across their business and ensuring that they continue to monitor and meet them.

The six key changes

1. Higher-quality capital and clarity over regulatory deductions to be taken at Tier 1
2. Increased capital requirements for trading book, securitisation and counterparty credit
3. Introduction of a leverage ratio
4. Establishment of a counter-cyclical capital buffer
5. Additional capital charges for systemically important international banks
6. Minimum liquidity standards

Basel in brief – The key papers

In 2010, the BCBS published the following:

- ☐ Calibration and phase-in arrangements
- ☐ The finalisation of both of the December 2009 BCBS capital and liquidity documents
- ☐ Publication of the consultative document *Countercyclical Capital Buffer Proposal* along with additional guidance regarding implementation.

Implementation in Europe –
Capital Requirements Directive summary

New regulatory requirements, including Basel III, are implemented within the European Union (EU) via the Capital Requirements Directive (CRD). The following summary identifies what new

1 Basel III timeline

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Common equity			Initial compliance					Full compliance	
Conservation buffer						Initial compliance			Full compliance
Liquidity coverage ratio	Regulatory reporting				Full compliance				
Net stable funding ratio		Regulatory reporting						Full compliance	
Leverage ratio			Regulatory reporting		Public reporting			Full compliance	
Counter-cyclical capital buffer						Anticipated application			
Other	CDR III adoption	CDR III compliance (anticipated) Translation of rules into local laws							

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regulations are due to be introduced and when they will take effect. A key change is that the application of the CRD III has now, for the majority, been pushed back to December 2011. Full implementation of CRD IV is now expected between 2013 and 2019.

Technical Provisions Amendment Directive (adopted July 2009)

- New rules on significant risk transfer (not in Basel II)
- Risk weighting of liquidity facilities increased
- Member States required to apply from December 31, 2010.

CRD II (adopted September 2009)

- Tier 1 hybrid capital eligibility
- Large exposure limits to single counterparties
- New Article 122(a) for securitisations (not in Basel II)
- Certain qualitative measures relating to liquidity management
- Member States required to apply from December 31, 2010.

CRD III (adopted November 2010)

- Incorporates BCBS July 2009 paper
- Remuneration – application January 1, 2011
- Resecuritisations risk weights introduced
- Securitisation 6% (internal ratings-based) risk weight removed
- Securitisation trading book versus banking book harmonisation
- Trading book capital requirements stressed – application pushed back to December 31, 2011
- Member States required to apply from December 31, 2011.

CRD IV (consultation phase)

- Consistent with BCBS December 2009 papers
- Currently awaiting revision to incorporate 2010 publications, including the proposals on the counter-cyclical buffer
- Implementation proposed between 2013 and 2019.

Impact assessment

The expectation is that many banks already hold the minimum capital requirements and that it will not be a major stretch for most of those that do not. This is likely to drive banks towards early adoption. It is worth noting, however, that regulators will be encouraged not to permit those who are already 'over-meeting' the requirements to erode their capital to minimum levels.

Institutions such as the German Landesbanks and mutual building societies will have to readdress what constitutes capital for them. However, in doing so, they have the benefit of both a 10-year 'grandfathering' period and a new certainty about the exact requirements they need to meet.

The implementation challenge

With many of the most contentious areas now addressed and quantified, banks at last know where they stand in relation to Basel III. So, having been focused equally on both the need to change and the impact, they are now concentrating on implementation.

This will not be a simple task. As they spend the next six months recalibrating their three- and five-year forecasts to take into account the impact of the new requirements, they will have many different areas on which to focus. For example, their gross balance sheet because of the leverage ratio, their capital base because of the new definition, and their liquidity in both the short and longer terms.

Although the final stages of Basel III contain little in the way of shocks or surprises, they still constitute a major implementation challenge. This must be met while banks also deal with the existing imperatives of rebuilding their capital and customer bases, and meeting their lending obligations to the market. In many ways, now that the dust has settled, the real work has only just begun.

Systemically important banks

The BCBS is currently addressing the issue of imposing extra capital requirements on banks that are systemically important to the financial system, with a proposal due in the coming months. In the meantime, some regulators, such as the Swiss, have already set their major banks with increased capital requirements and, in the absence of a Basel Directive, further local regulators are likely to follow suit in the near future.

IFRS 9: Financial instruments – Overview and impacts

The International Accounting Standards Board (IASB) continues the process of drafting IFRS 9, the replacement standard for IAS 39.

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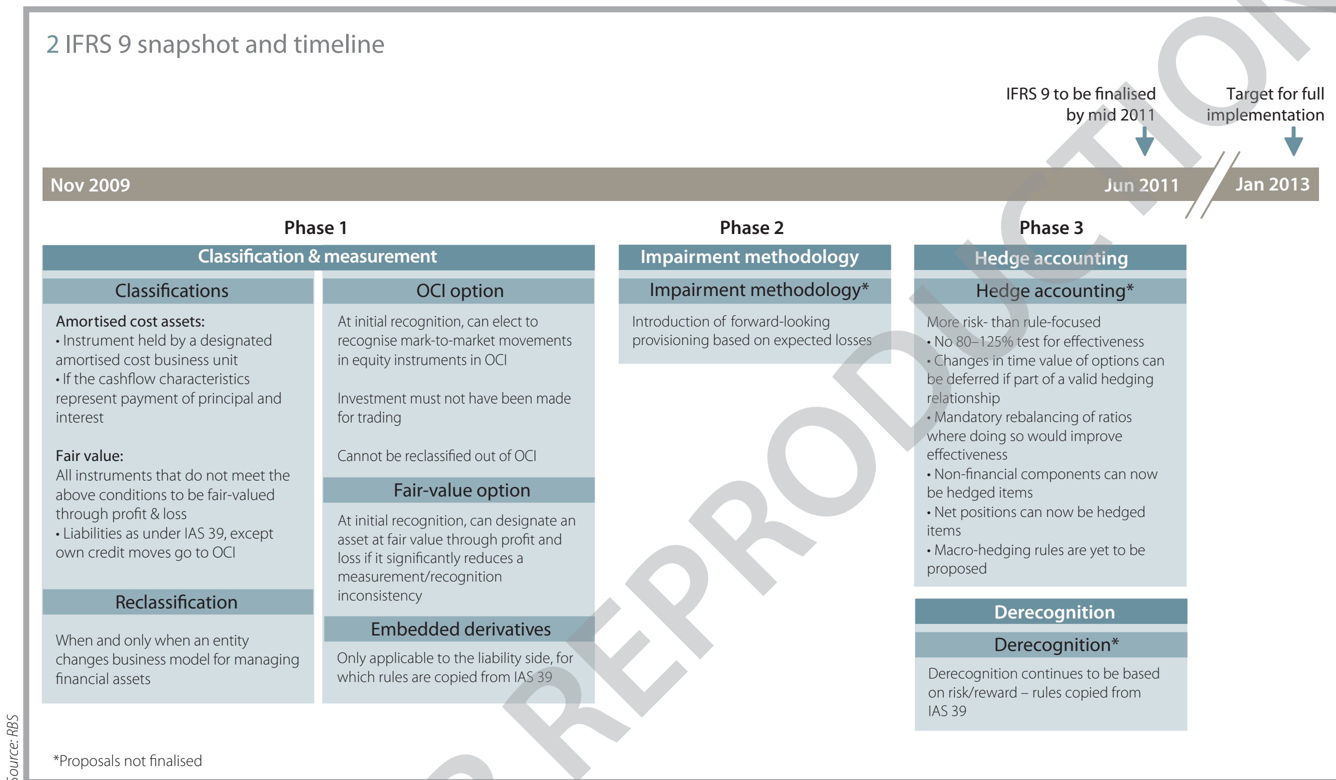

The potential impact of IFRS 9 on a bank's capital base may be significant and, accordingly, many capital management teams are following this process with interest. The process will not be finalised before mid-2011, with full implementation due to begin in January 2013. However, in Europe, many believe this will slip back into 2014 or 2015 as it will need to go through the EU parliament in its entirety before it can become law.

The proposals

The IASB's open project to replace IAS 39 with IFRS 9 comprises three phases:

- Phase 1: Classification and measurement
- Phase 2: Impairment methodology
- Phase 3: Hedge accounting

The EU is yet to endorse any of these proposals, awaiting publication of all phases of IFRS 9. But, with the third phase now published, it is likely there will be little scope to avoid or delay implementation without the risk of putting the EU out of kilter with the rest of the world.

Key impacts

Key changes, some of which are currently proposals only, include:

- Generally simpler classification and measurement approaches
- Non-vanilla financial assets will be subject to mark-to-market accounting
- Own credit spread moves for liabilities designated as fair value go to reserves
- Subordinated securitisation assets will be subject to mark-to-market accounting (a partial reversal of the 2008 reclassifications)
- No subsequent reclassification
- Change to an expected-loss calculation for the forward provisioning of credit losses
- The time value of options may now be more easily subject to hedge accounting
- More risk management focused hedge accounting, including the removal of the 80–125% test for effectiveness and mandatory rebalancing of hedging ratios
- Net positions, components of non-financial items and aggregate exposures including derivatives can now be hedged items
- Increased disclosure requirements.

Figure 2 illustrates the timings and summaries of these key changes.

At RBS we are fully committed to understanding our clients' needs and those of the markets in which they operate. We hope this update provides a useful guide to the requirements of both the Basel III and IFRS 9 regulatory and accounting reforms.

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