Loan Market Association
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Impact of Basel III on the loan market

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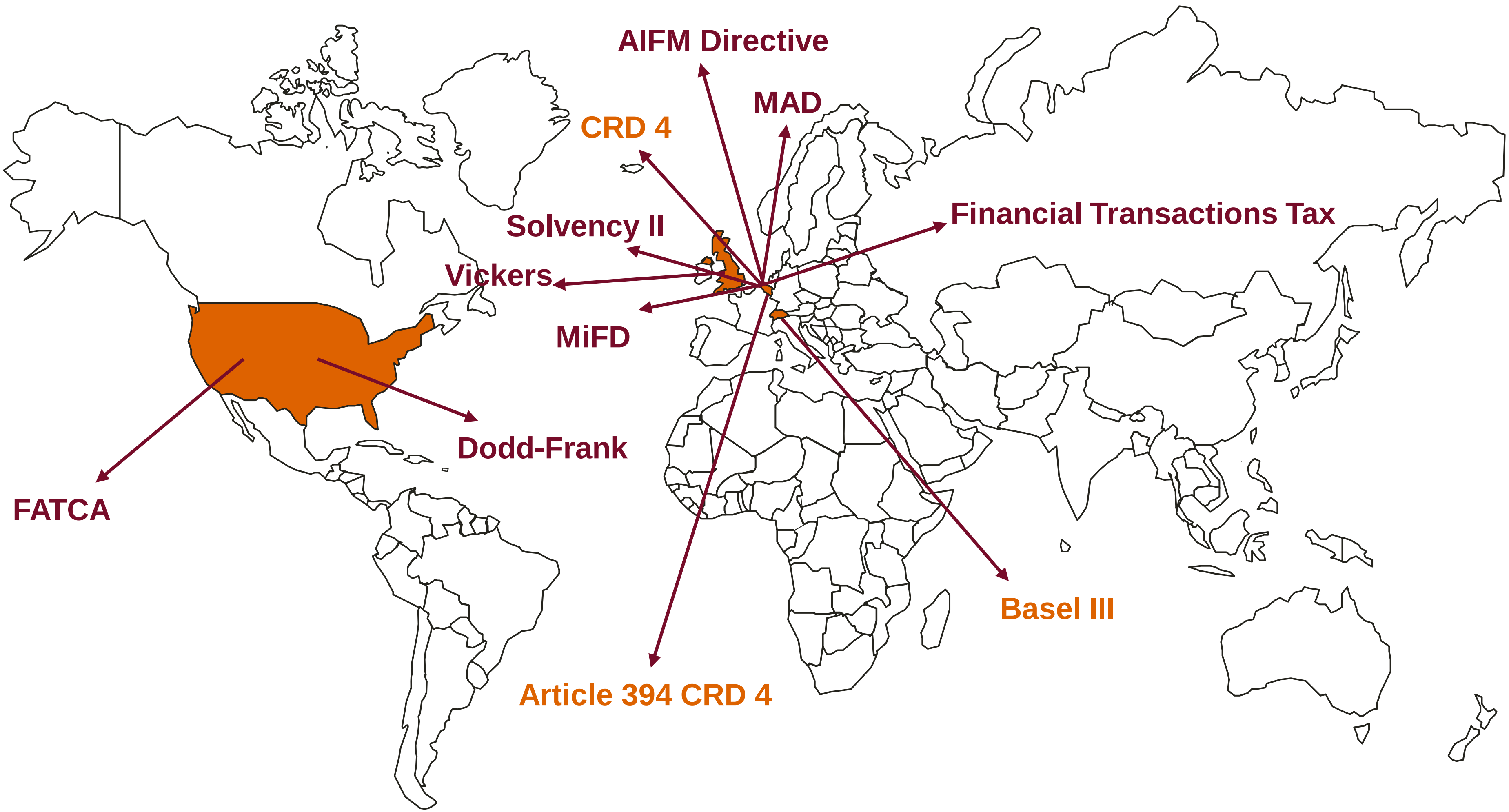
Global regulation deluging the market



Basel III

- Basel II focus: regulatory capital allocation but <u>not</u> designed to increase overall capital requirements (rather an incentive to use more sophisticated pricing concepts, e.g. margin ratchets)
- Basel III <u>is different</u> as it introduces three new key ratios along with increased quantity and quality of capital requirements with cost and profitability implications
- **Basel III will be implemented at a European level by way of a capital requirement directive („CRD-4“) (*requires implementation by way of national legislation*) and a capital requirement regulation („CRR“) (*directly applicable*)**
- **This proposal is subject to the trialogue - discussions between the European Commission, Council and Parliament – conclusion unlikely before end October (*implementation scheduled for January 2013!*)**

Basel III - key new ratios

RATIO	Liquidity coverage ratio (LCR)	Net stable funding ratio (NSFR)	Leverage ratio
Rationale	– Maintain a pool of highly liquid assets at least in the amount of hypothetical 30 days cash outflows (stress scenario)	– Maintain a stable funding mix to endure a year-long liquidity crisis	– Restrict the absolute level of indebtedness which a bank may take on – A non-risk-sensitive capital requirement
Timing	– Observation period began in Jan. 2011 – Reporting requirement from Jan. 2013 – Compliance starting Jan. 2015	– Observation period began in Jan. 2011 – Reporting requirement from Jan. 2013 – Compliance starting Jan. 2018	– Observation period began in Jan. 2011 – Reporting to regulator from Jan. 2013 – Public disclosure from Jan. 2015 – Compliance starting Jan. 2018

Liquidity Coverage Ratio

Assets will be categorised as Level 1 or Level 2 to reflect their liquidity character

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days} = \text{outflows} - \text{Min}\{\text{inflows}; 75\% \text{ of outflows}\}} \geq 100\%$$

Liquidity Coverage Ratio (cont'd)

Stock of high-quality liquid assets

Level 1
- 100% of LCR
- cash and other proven high-quality assets (0% rísk-weight)

Level 2
- max 40% of LCR
- proven high-quality assets (20% risk-weight)
- 15% hair-cut on market value
- incl corp/covered bonds

Operational Requirements
- Ensure appropriate availability
- No encumbrances
- No co-mingling with/use as hedges
- Separate function to control
- Not to cover intra-day liquidity needs
- One currency for reporting but assets in appropriate currencies
- Separate solutions for currencies with shortage of liquid assets
- Less reliance on external ratings

Liquidity Coverage Ratio (cont'd)

Total net cash outflows over the next 30 calendar days
=
outflows – Min {inflows; 75% of outflows}

Outflows

Retail deposits:
- Stable: min 5 %
- Less stable: min 10%

Wholesale deposits – unsecured:
- Unsecured small business = retail
- Unsecured w/operational relationship: 25%
- Unsecured non-financials and sovereigns: 75%
- Unsecured other: 100%

Wholesale deposits – secured:

Categories for outstanding maturing secured funding transactions	Amount to add to cash outflows
• Backed by Level 1 assets.	0%
• Backed by Level 2 assets.	15%
• Secured funding transactions with domestic sovereign, central banks or PSEs that are not backed by Level 1 or 2 assets. PSEs that receive this treatment should be limited to those that are 20% or lower risk weighted.	25%
• All others	100%

Additional requirements:
- Derivatives payables: 100%
- Increased liquidity needs for embedded downgrade triggers: 100% (of collateral needed)
- Changes to collateral valuation: 20% (of non-Level 1 collateral posted)
- Structured-product funding: 100%
- AB CP, SIVs etc: 100% (maturing amount/returnable assets)
- Draw-downs on committed credit/liquidity facilities, retail and small businesses: 5%
- **Draw-downs on committed *credit* facilities, non-financials, sovereigns: 10%**
- **Draw-downs on committed *liquidity* facilities non-financial, sovereigns: 100%**
- Draw-downs on committed credit and liquidity facilities to all others: 100%

Liquidity Coverage Ratio (cont'd)

Total net cash outflows over the next 30 calendar days
=
outflows – Min {inflows; 75% of outflows}

Inflows

In order to
- **prevent banks from overreliance on anticipated inflows and**
- **ensure minimum liquidity coverage**

inflows to off-set outflows capped at 75% of expected outflows

Inflows from:
- credit lines with other institutions: 0%
- retail/small business: 50% of contractual inflow
- counterparty-specific inflow estimates
- financial debtors: 100%
- non-financial wholesale debtors: 50%
- operational inflows: 0%
- other contractual inflows: set by national supervisors

Net Stable Funding Ratio

”Available Stable Funding”: the portion of equity and debt financing expected as reliable sources of funds over a 1-yr horizon under conditions of extended stress

- Intended to change the *liquidity structure* of banks to reduce the reliance on short-term funding for long-term assets
- The amount required is a function of the liquidity characteristics of assets held, OBS contingent exposures and/or the activities pursued by the bank
- No double counting with LCR assets

Available amount of stable funding

Required amount of stable funding

>100%

- RASF calculated as the sum of the value of assets held and funded multiplied by a specific required funding (RSF) factor for each asset type

Net Stable Funding Ratio (cont'd)

To ensure stable funding on an ongoing, viable entity basis over 1 yr in extended firm-specific stress where a bank encounts and investors/customers become aware of:

- **significant decline in profitability or solvency due to heightened credit risk, market risk or operational risk and/or other risk exposures and/or**
- **potential downgrade in debt, cp credit or deposit rating by recognised rating organisation and/or**
- **material event that calls into question reputation or credit quality of the bank**

***Available* Stable Funding: Total ASF=sum of weighted amounts**

ASF Factor	Components of ASF Category
100%	• The total amount of capital, including both Tier 1 and Tier 2 as defined in existing global capital standards issued by the Committee • The total amount of any preferred stock not included in Tier 2 that has an effective remaining maturity of one year or greater taking into account any explicit or embedded options that would reduce the expected maturity to less than one year. • The total amount of secured and unsecured borrowings and liabilities (including term deposits) with effective remaining maturities of one year or greater excluding any instruments with explicit or embedded options that would reduce the expected maturity to less than one year. Such options include those exercisable at the investor's discretion within the one-year horizon.[30]
90%	• "Stable" non-maturity (demand) deposits and/or term deposits (as defined in the LCR in paragraphs 55-61) with residual maturities of less than one year provided by retail customers and small business customers.[31]
80%	• "Less stable" (as defined in the LCR in paragraphs 55-61) non-maturity (demand) deposits and/or term deposits with residual maturities of less than one year provided by retail and small business customers.
50%	• Unsecured wholesale funding, non-maturity deposits and/or term deposits with a residual maturity of less than one year, provided by non-financial corporates, sovereigns, central banks, multilateral development banks and PSEs.
0%	• All other liabilities and equity categories not included in the above categories.[32]

Net Stable Funding Ratio (cont'd)

Components of RSF Category	RSF Factor
• Cash • Unencumbered short-term unsecured instruments/transactions w/remaining maturity <1yr • Unencumbered sec's w/stated maturities <1yr without option to prolong • Certain off-settable securities holdings under reverse repos • Unencumbered loans to financials w/ maturities<1yr and no option to prolong and a call for lender	0%
• Unencumbered marketable sec's w/maturities<1 yr issued by sovereigns etc w/0% risk weight with active markets	5%
• Unencumbered corp. or covered bonds rated AA or better with remaining maturity≥1 yr qualifying as LCR Level 2 • Unencumbered marketable sec's w/maturities<1 yr issued by sovereigns etc w/20% risk weight qualifying as LCR Level 2	20%
• Unencumbered gold • Listed non-financial equities, included in large cap index • Unencumbered corp/covered bonds that are central bank eligible, not issued by financials (except covered bonds), not issued by the bank itself, low credit risk AA- to A- • Unencumbered loans to non-financials, sovereigns etc w/maturities<1 yr	50%
• Unencumbered residential mortgages with 35% risk weight • Other unencumbered loans with remaining maturity ≥1 yr w/risk weight 35%	65%
• Unencumbered retail and small business loans w/maturities<1yr (other than those at 65% above)	85%
• All other assets	100%

Leverage Ratio

$$\frac{\text{qualifying capital}}{\sum \text{(gross asset value)}} > \text{required ratio}$$

capital requirement ratio:

$$\frac{\text{qualifying capital}}{\sum \text{(risk weighting x asset value)}} > \text{required ratio}$$

Leverage Ratio (cont'd)

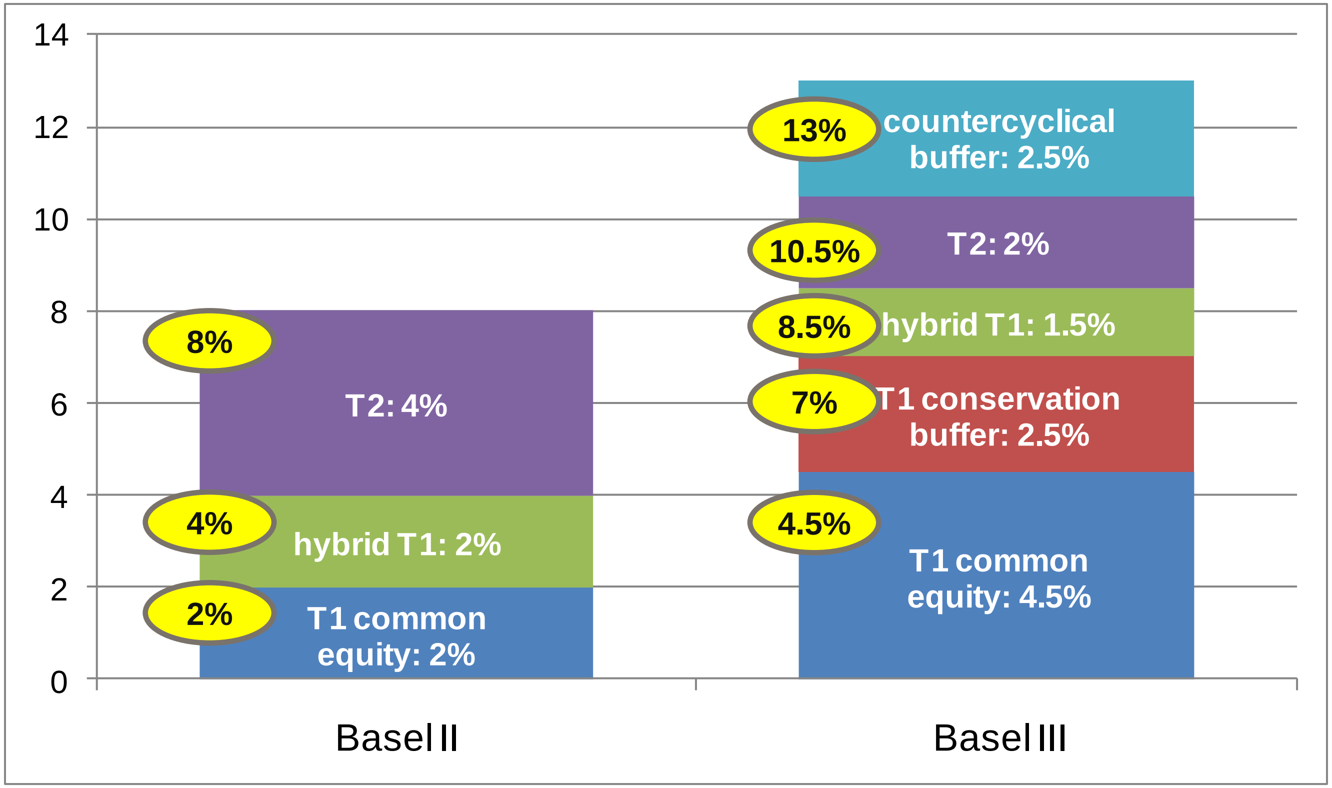
- **Non-risk-based backstop cap to gross exposures**
- **Probably 3%, probably tier 1 capital only**
- **Gross exposures:**
  - All assets, also cash and highly liquid
  - Ignore guarantees and collateral
  - Ignore netting (save for derivatives)
  - Include repos
  - Include full value of
    - Lending commitments
    - Trade finance commitments
    - Standby letters of credit and guarantees

Capital Requirements

$$\frac{\text{qualifying capital}}{\sum \text{(risk weighting x asset value)}} > \text{required ratio}$$

Capital Composition Range

SIFI buffer: 4%?



Risk weighting: premium for exposure to financial institutions

- **1.25 multiplier to correlation adjustment (ie up to 35% increase in risk weighting) for exposures to:**
  - banks, broker/dealers and insurance companies if large (above $100bn assets)
  - all unregulated financial entities (hedge funds, SICs, SPVs, SWFs, etc) regardless of size
- **PD for exposures to counterparties which are “highly leveraged” or own traded assets should reflect performance of those assets in periods of stressed volatilities**

What does all this mean?

Impact on products: Trade Finance

- **Many aspects affected:**
  - frequent interbank exposures, through L/Cs – up to 35% increase in capital requirements
  - L/C and other commitments counted in full for leverage ratio (3% tier 1 requirement)
  - guarantees ignored for leverage ratio
  - x% (at national or EU discretion) of L/Cs must be invested in liquidity pool
  - x% (at national or EU discretion) of L/Cs must be covered by stable funding

specialised lending (including structured finance and trade finance, among other businesses) is among the most affected

(McKinsey, Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation, November 2010)

Impact on products: Loans vs. CP / EMTN

- **Corporate loan**
  - not eligible for liquidity pool
  - if < 1 year, 50% to be covered by stable funding
  - if > 1 year, 100% to be covered by stable funding
- **Corporate CP / EMTN**
  - if AA- rating or better, eligible for liquidity pool
  - if < 1 year, no need for stable funding
  - if > 1 year, 20% (AA rating or better) or 50% (A- to AA- rating) to be covered by stable funding

Impact on products: Revolving Facilities

- **Undrawn commitments**
  - 3% tier 1 capital requirement, because of leverage ratio (Basel II / III standardised: 50% credit conversion if > 1 year, 20% if < 1 year)
  - 5% stable funding requirement
  - 10% must be invested in liquidity pool (or 100%)

- **Loan special characteristics**
  - Anchor for Client relationships
  - Flexible Credit/structure
  - Funds certain/working capital
  - Confidentiality/speed of response

What is the LMA doing in the regulatory area?

- Lobbying
- Documentation

Lobbying/submissions activity

- UK
  - Bank of England
  - Financial Services Authority (FSA)
  - HMT
- Europe
  - European Commission
  - European Banking Authority
  - Basel Committee on Banking Supervision
  - MEPs
- USA
  - Federal Reserve Bank
  - Securities and Exchange Commission (SEC)
  - Internal Revenue Service (IRS

Recent submissions to regulators

- CRD IV response to European Commission
- Article 122a/394 (Exposures to transferred credit risk) of Directive 2006/48/EC (the "CRD") and Collateralised Loan Obligations ("CLOs")
- Response to the EBA (CEBS) Consultation Paper on Guidelines to Article 122a of the Capital Requirements Directive
- Response in relation to Dodd-Frank Risk Retention Rules
- Comments to IRS and others in relation to the Foreign Account Tax Compliance Act (FATCA)

Recent submissions to regulators (cont'd)

- Response to the Commodity Futures Trading Commission and Securities and Exchange Commission on the definition of "swaps" under "Dodd-Frank“
- Response to European Commission Consultation in relation to the Review of the Markets in Financial Instruments Directive (MiFID)
- Response to the EU consultation re cross-border interest payments
- BIS Call for Evidence: Improving Access to Non-Bank Debt
- Vickers report consultation

LMA Documentation – tackling regulatory issues

Basel III

- Footnote on treatment of Basel III under Increased Costs clause – see facility documentation
- Note re impact of using Basel II Increased costs exclusion language in relation to Basel III
- LMA Note on the Basel III Liquidity Coverage Ratio and Loan Documentation

CONCLUSION - impact on lending

- More homogenous behaviour > reduced effective liquidity
- Differential implementation > uneven playing-field (intra-EU, EU-USA)
- Additional competition for liquid assets > shortage of liquid assets (esp. as public finances retrench) > higher liquidity costs > higher funding costs for banks and other financial institutions > higher lending margins > cost pressure on real economy
- Restrictions on banks' asset growth > deleveraging > reduced activity in real economy

QUESTIONS

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