

## New and Upcoming Capital, Liquidity, and ALLL Standards October 7, 2009

### Introduction

The details and timing of new capital and liquidity requirements are becoming clearer, particularly after the September 25 Pittsburgh Summit where G-20 leaders endorsed much of the work of international bank supervisors in these areas. There may be some flexibility in the details, but there is no question at this point that these initiatives have substantial official support and priority. Moreover, in some jurisdictions, including the US, some informal implementation has already begun even though the regulatory process has not been completed.

### Changes to Capital Requirements

The Basel Committee on Banking Supervision (BCBS) finalized the first crisis-response revisions to the capital framework in July of this year. These revisions were primarily oriented at securitization activity. In the US, there will be an interagency NPR to implement these changes in the first quarter of next year and banks will be expected to comply with the standards by year-end 2010.

The amendments to the minimum capital requirements include:

- Higher risk weights for resecuritization exposures<sup>1</sup> for both standardized and IRB approach, regardless of where the position is held;
- New requirements that banks perform their own due diligence for securitization risk weights, and do not rely solely on rating agencies;
- Tightening up of the treatment of liquidity facilities;
- The addition of an incremental risk charge, to cover default and migration risk for trading exposures; and
- The introduction of a stressed value-at-risk requirement.

One aspect of the amendments has caused particular concern among some bankers. While in general the amendments apply standard risk weights to calculate the new incremental risk charge for securitized products, one outcome of this is to impose a seemingly onerous charge on hedged portfolio trading<sup>2</sup>. A limited exception has been

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<sup>1</sup> Resecuritization exposures are defined by the BCBS as “a securitization exposure in which the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitization exposure.” (<http://www.bis.org/publ/bcbs157.pdf?noframes=1>).

<sup>2</sup> The concern relates to the specific risk capital charges that would be applied to a portfolio of rated securitization exposures hedged by offsetting investments in indices. The specific risk capital charge for this type of “correlation” portfolio of rated securitization exposures hedged by short positions in an unrated index will be computed as the greater of the charge for the long positions and the charge for the short positions, the latter which, being unrated, draw a 100% charge.

given for this situation, where banks may calculate a comprehensive risk capital charge subject to strict requirements, but it is not considered sufficient to many bankers.

There were also amendments to Pillar 2, which sets forth expectations about banks' internal capital adequacy assessment processes (ICAAP). The Pillar 2 enhancements encompass firm-wide risk oversight and specific risk management topics. The amendments highlight in particular the expectations around the management of

- Risk concentrations;
- Securitization risk and off balance sheet exposures;
- Reputation risk;
- Valuation practices;
- Liquidity risk management; and
- Stress testing practices.

Additional upcoming revisions to the Basel II framework have been announced, and these plans have been endorsed by various governments and international bodies including the G-20 Leaders at their recent summit. Proposals are expected by year end and implementation by year-end 2012 at the latest. These include<sup>3</sup>:

- A supplemental leverage ratio – probably like that already in use in the US, but possibly with some simple risk-weighting;
- Refocus of Tier 1 capital on common equity; and
- Development of a counter-cyclical capital buffer that would require banks to build up capital during economic expansions.

In addition, the Financial Stability Board has been tasked by the G-20 Leaders to come up with a proposal for a supplemental capital charge and other possible requirements for systemically significant banks by October 2010.

We understand that the coming changes to capital will be subject to calibration during 2010, which means that supervisors will seek data from banks to determine the impact of the proposals. Nonetheless, banks will need to prepare for a new capital framework that imposes higher requirements on certain activities as well as higher overall capital requirements. Banks should revisit their internal capital adequacy assessment processes to ensure they are forward-looking and based on sophisticated measurements as well as stress testing. In addition, bank management must ensure that their business plans, product decisions, and trading strategies reflect the new capital regime.

### **Changes to Liquidity Risk Management Requirements**

Liquidity is attracting significant attention among supervisors, because the recent crisis showed significant gaps in banks' liquidity measurement and planning. BCBS issued liquidity guidance in September 2008 to strengthen liquidity risk management; US

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<sup>3</sup> For additional information on this announcement, see Promontory's client letter (<http://www.promontory.com/assets/0/78/110/250/61ebfeaa-2ce3-4851-a254-6c1a6449682e.pdf>).

agencies followed with similar guidance in July 2009. In the UK, a major step was taken this week to increase liquidity with the FSA's publishing new rules that will take effect from December 2009 but mainly in 2010. Over roughly four years, according to the FSA, the current £280 billion of high-quality liquidity held by banks in the UK, including foreign branches, could have to rise sharply, by as much as 300% in a worst-case scenario unless banks significantly extend the maturity of their wholesale funding in the meantime.

The BCBS will propose an explicit liquidity framework by year-end, which will have a stressed funding ratio and a longer-term structural liquidity ratio. While the specifics of the coming liquidity framework are not yet known, banks should already be enhancing their liquidity risk management processes, including improving data collection, measurement techniques, and contingency funding plans.

### **Focus on Credit Quality**

As is not surprising at this point in the cycle, supervisors are finding significant credit quality problems at many banks. One example of this trend can be found in the US banking agencies' recently released Shared National Credits Program 2009 Review (<http://occ.treas.gov/ftp/release/2009-111a.pdf>), where this year criticized assets rose by over 70% and classified assets nearly tripled. This has prompted some additional scrutiny on the ALLL and credit risk management processes. Banks can expect supervisors to be on alert for risk management weaknesses that are reflected in ALLL inadequacies, loan rating deficiencies, and the like. Supervisors will also be urging banks to be more forward looking in their reserve calculations, consistent with accounting standards. This would be an excellent time for banks to review the effectiveness of credit risk management, the accuracy of risk ratings, identification of credit deterioration and the adequacy of the ALLL. Staying ahead of the supervisors will not only build credibility but avoid possible capital penalties for perceived ALLL and risk management deficiencies.

### **Conclusion**

As Promontory and others have been predicting, global supervisors are moving forward with determination to increase capital and liquidity in banks, and to enforce high standards of risk management. Not all of these changes may be easy to digest, and some may be subject to modest revision, but the direction is more than clear. Banks that accept and work to adapt to the new supervisory vision will be in the best position to succeed in the post-crisis world.