

# An Overview of Basel III

## An evolving framework for banks

November 16<sup>th</sup> 2010

HSBC 

**Sean McNelis**

Head of Hybrid Capital & Liability  
Management Solutions – Asia-Pacific

Tel: +852 2822 4157

Email: [seanmcnelis@hsbc.com.hk](mailto:seanmcnelis@hsbc.com.hk)

HSBC 

The world's local bank

# The Background to Basel 3

## Overview

- Basel 2 focused on 'asset side' of B/S. Basel 3 focuses mostly on 'liability side':
  - definition of capital
  - liquidity
- Post the Global Financial Crisis, focus of regulation on :
  - Longer-term / stable liquidity
  - Leverage ratios (RWA framework can't be arbitrated)
  - Higher quality of capital (e.g. equity, CoCos, loss absorbing hybrids)
  - Higher quantity of capital

## Key Changes

✓

- Focus on equity

✓

- New regulations on the definition of T1 & T2 debt capital

✓

- New (higher) minimum capital requirements

✓

- Leverage ratios

✓

- Liquidity ratios (LCR & NSFR)

# Basel 3 & Bank Capital

## Definition of Capital

- Focus on core equity / Hybrids to be more “equity-like”
- No step-ups in Tier 1 or Tier 2 capital
- Upper and Lower Tier 2 distinction abolished; Tier 3 abolished

## Capital Deductions

- Most deductions from regulatory capital now against core equity
- What is the relevance of T2?
- Banking groups with significant DTAs, minorities, insurance subsidiaries most affected

## Liability Management

- Opportunistic buy-back of hybrids at lower prices (create accounting gains)
- Address ‘old’ structures via tenders / exchange / modification – UT2 Capital
- Final grandfathering rules under Basel 3 will be key

## Contingent Capital

- Certain regulators & Governments (UK / Canada/ Switzerland) favour contingent capital to deal with future banking crises
- Debt instrument that a) converts to equity or b) is written down when the bank in crisis
- Limited demand from investors for the product currently

## Minimum Capital Ratios

- Higher minimum capital ratios – equity T1 ratios from 2% to 7%
- National regulators have discretion – capital conservation buffer & countercyclical buffer

# The December 2009 Basel Proposals

## The Proposals

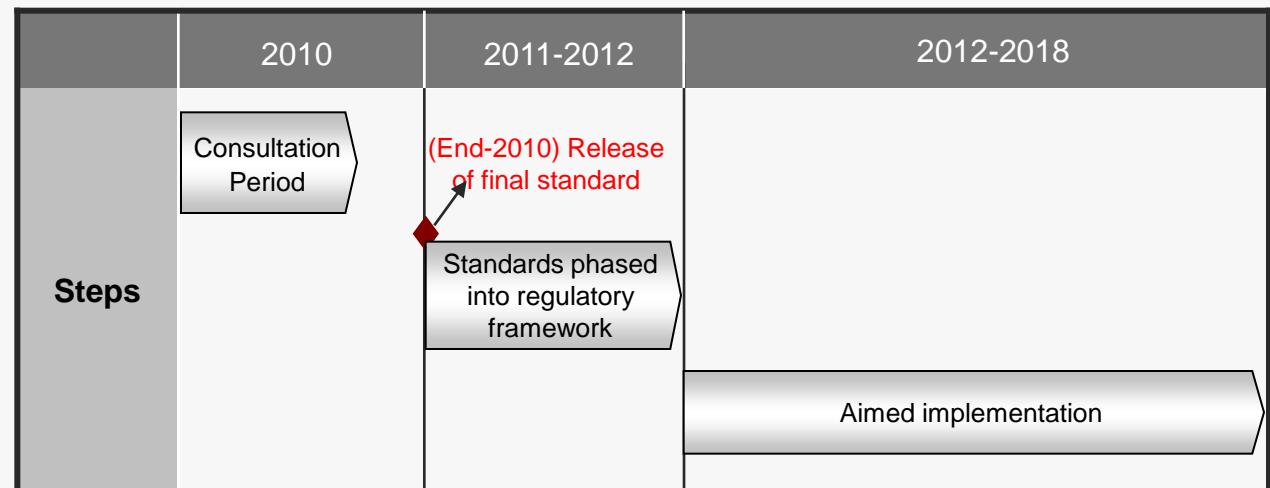
- The Basel Committee on Banking Supervision (BCBS) released in December 2009 a consultation document titled “*Strengthening the Resilience of the Banking Sector*”

## Key Areas Under Review

- The regulatory capital base, quality, consistency and transparency
- Capital requirements for counterparty credit risk
- Introduction of a leverage ratio
- Countercyclical capital framework
- Minimum liquidity standard

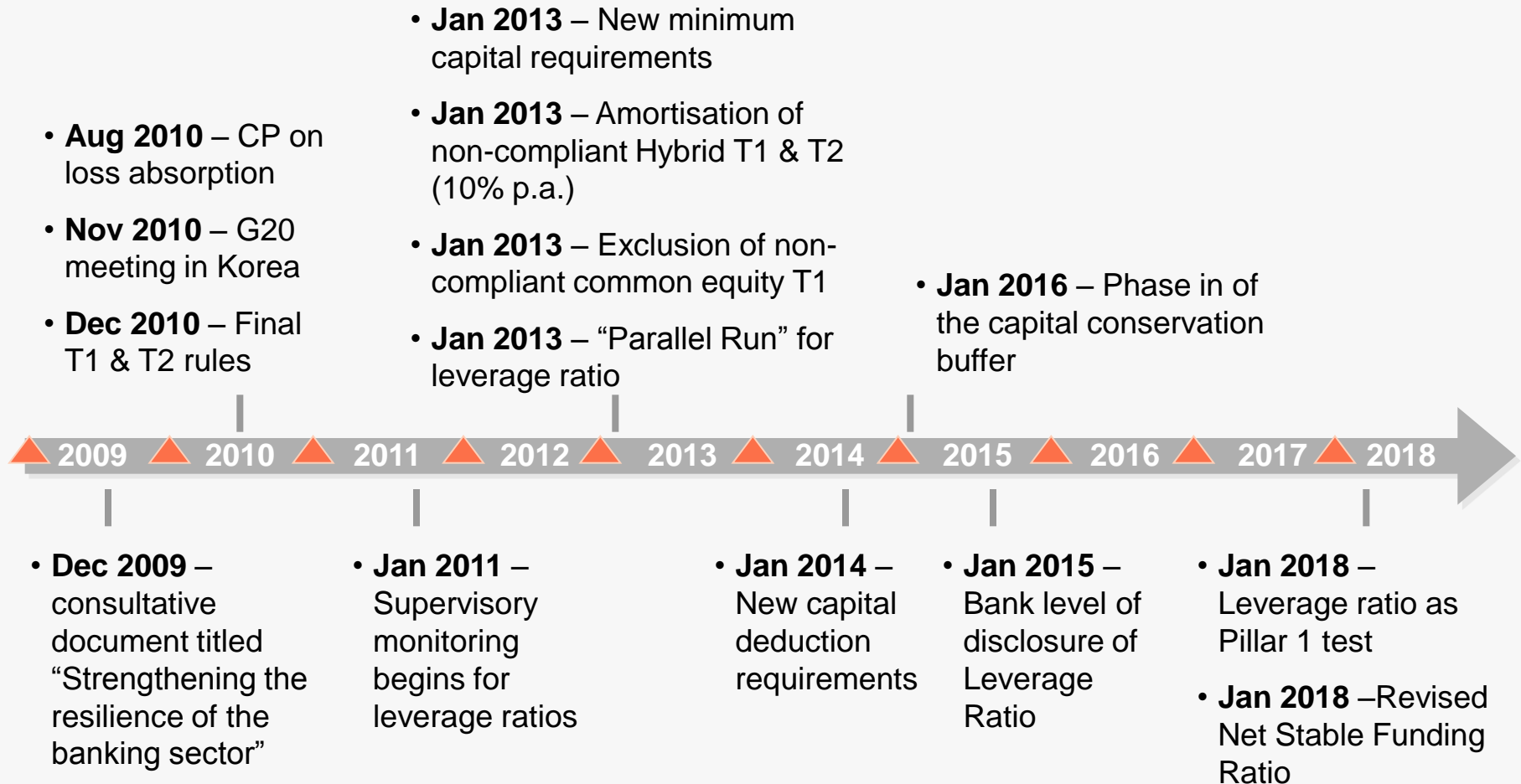
## Planned Implementation Timeline

- Full set of standards by the end of 2010 (on track!!)
- Full implementation is aimed for by the end of 2018



# Basel III Consultation & Implementation Timeline

## Implementation timeline runs to 2018

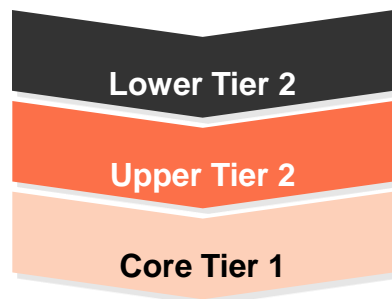


# Re-Defining the Capital Base...

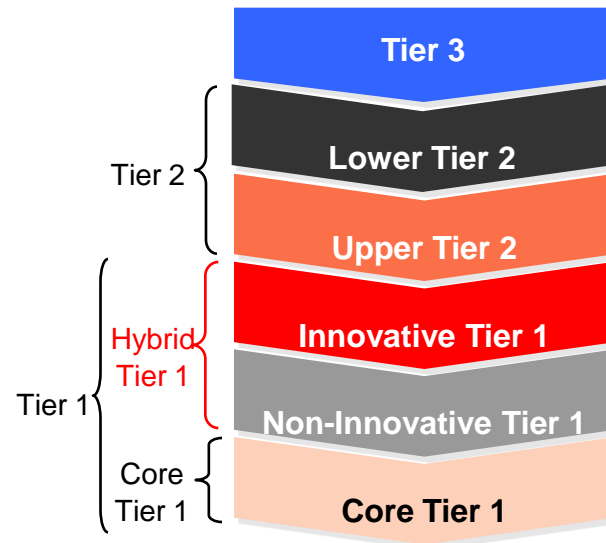
- The Basel III proposals redefine the composition of regulatory capital
- Under the proposals:
  - Focus on core equity
  - Innovative Tier 1 (with step-up feature) would not be recognised
  - Upper Tier 2 is abolished

## Overview of Bank Capital Structure

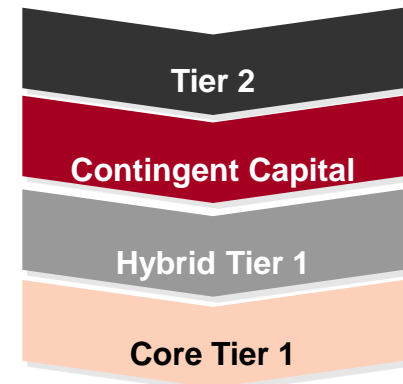
### CHINA'S CURRENT BANK CAPITAL FRAMEWORK



### INTERNATIONAL BANK CAPITAL FRAMEWORK



### PROPOSED BASEL III FRAMEWORK



# Update on Basel's Minimum Capital Standards (Sept 2010)

- On 12 September 2010, the Basel Committee announced the new minimum capital requirements. Final rules expected in Dec 2010

## Minimum Capital Requirement

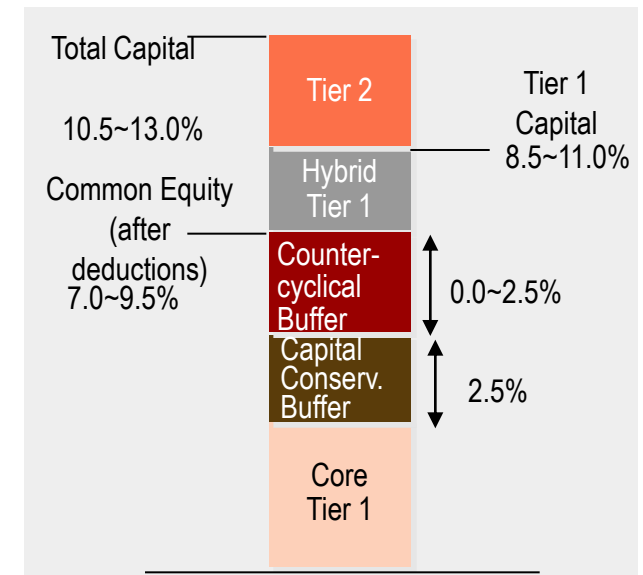
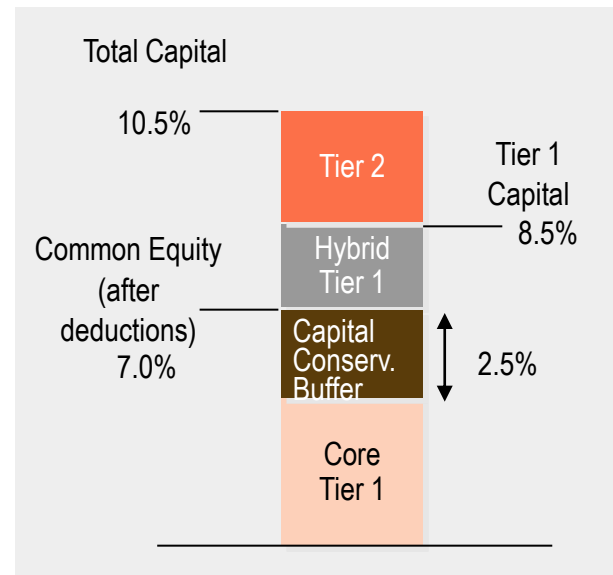
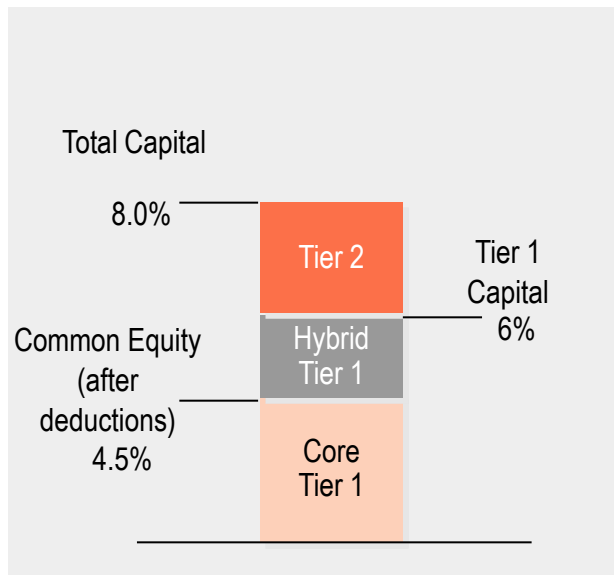
- Minimum common equity ratio increases from 2% to 4.5%

## Capital Conservation Buffer

- Capital conservation buffer of 2.5% must be met with common equity (after regulatory adjustment)

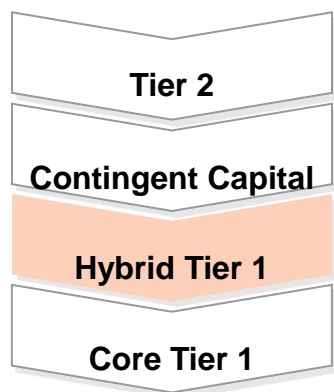
## Countercyclical Buffer

- A countercyclical buffer (0.0%~2.5%) of common equity or other loss absorbing capital will be introduced



# New Definition for Hybrid Tier 1 Instruments

- The biggest impact of the proposed new Basel rules is likely to stem from the removal of step-ups, more stringent requirements for coupon discretion as well as a stronger form of principal loss absorption



## Features

- No step-ups

- Non-cumulative

- Loss absorption

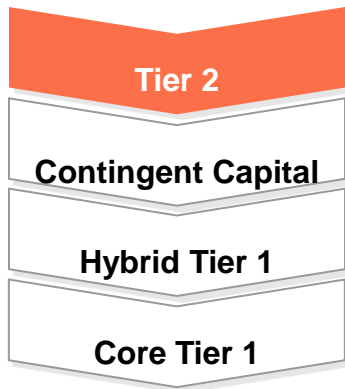
- *Resolution regimes*

- *'Bail in'*

- T1 hybrids more “equity-like”

# New Definition for Tier 2 Instruments

- With the exception of the removal of step-ups, the proposed Tier 2 rules are in many respects similar to existing Tier 2 rules. Debate on adding “non-viability” triggers continues



## Features

- No step-ups

- Loss absorption at the point of “non-viability”

- *Resolution regimes*

- *‘Bail in’*

- T2 debt more risky for investors

# Latest Proposals On Regulatory Capital Loss Absorption

- The Basel Committee issued a consultative document titled “Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability” on Aug 19 2010

## Regulatory Capital Loss Absorbency

- All **non-common equity bank regulatory capital instruments** (including Tier 2 and Hybrid Tier 1 capital) should be capable of absorbing losses in the event that a bank is unable to support itself in the private market, through:
  - **Permanent write-down of principal; or**
  - **Conversion to equity**

## Rationale

- Many regulatory capital instruments do not absorb losses in gone-concern situations
- During the Global Financial Crisis, banks capital instruments have not taken losses in many circumstances (even where the Government invested in the bank)

## Basel Proposed Solution

- Gone-concern loss absorbency would continue to work through subordination in liquidation for failed banks
- The regulatory authority has the option to require non-common equity regulatory capital instruments to be permanently written-off or converted into common shares

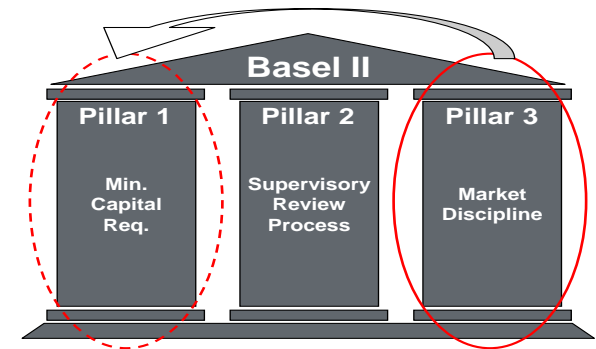
# Introduction of a Leverage Ratio... by 2018

## Objectives

- Put a floor under the build-up of leverage in the banking sector
- Provide additional backstop against model risk and measurement errors
- Stop “arbitraging” of RWA approach

## Key Idea

- Migrating leverage ratio from a Pillar 3 to a Pillar 1 treatment based on future review and calibration



## Latest Review

### BCBS Original Proposals

- The Leverage Ratio is designed as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment
- Netting is not allowed
- Certain Off-Balance Sheet items should be included using a flat 100% Credit Conversion Factor

### Key Amendments (vs. Dec09 Proposals)

- Proposed minimum 3% (i.e. 33 times leverage) to be tested, based on new definition of Tier 1 capital
- Calculated as an average over a quarter
- For all derivatives netting is allowed
- 10% Credit Conversion Factors for Off-Balance Sheet items

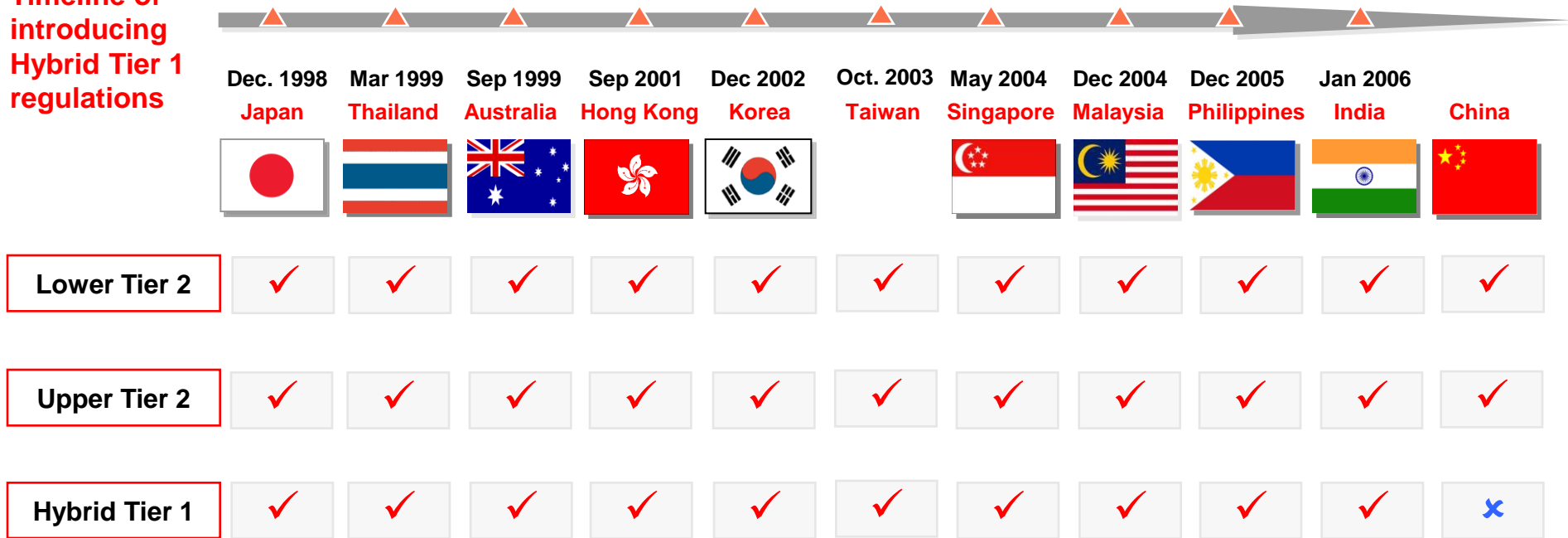
# A role for Hybrid Capital in the Future?

- Banks tend to use subordinated debt to enhance RoE, whilst meeting reg. requirements
- Tax deductible “equity” will continue to make sense for banks

<b>Regulatory Capital</b>	<ul style="list-style-type: none"><li>• Can be recognised by regulators as Tier 1 or Tier 2 in calculating the issuing bank’s capital adequacy, depending on local regulations</li></ul>
<b>Non-Dilutive</b>	<ul style="list-style-type: none"><li>• Structured as a fixed-income instrument without voting rights and thus is non-dilutive to existing shareholders (other than where equity conversion is included)</li></ul>
<b>Lower Cost</b>	<ul style="list-style-type: none"><li>• Lower cost of capital due to its “quasi-equity” nature and tax benefits</li><li>• More favorable WACC compared to the use of pure equity capital</li></ul>
<b>Diversification</b>	<ul style="list-style-type: none"><li>• Expansion of possible sources of regulatory capital</li><li>• Diversification of investor base (issue in foreign currency)</li></ul>
<b>Tax Benefits</b>	<ul style="list-style-type: none"><li>• Tax deduction on interest is a key driver of issuance</li></ul>
<b>Equity Credit</b>	<ul style="list-style-type: none"><li>• Equity credit from rating agencies in financial analysis</li></ul>

# Existing Bank Capital Framework in Asia-Pacific

## Timeline of introducing Hybrid Tier 1 regulations



- Capital regulations are well developed across the Asia-Pacific region
- Basel 3 will lead to changes in the definition of capital in the region
- China will be in a position to adopt the new Basel 3 capital rules allowing banks to issue the new generation of instruments across the capital spectrum

# The role for Contingent Capital?

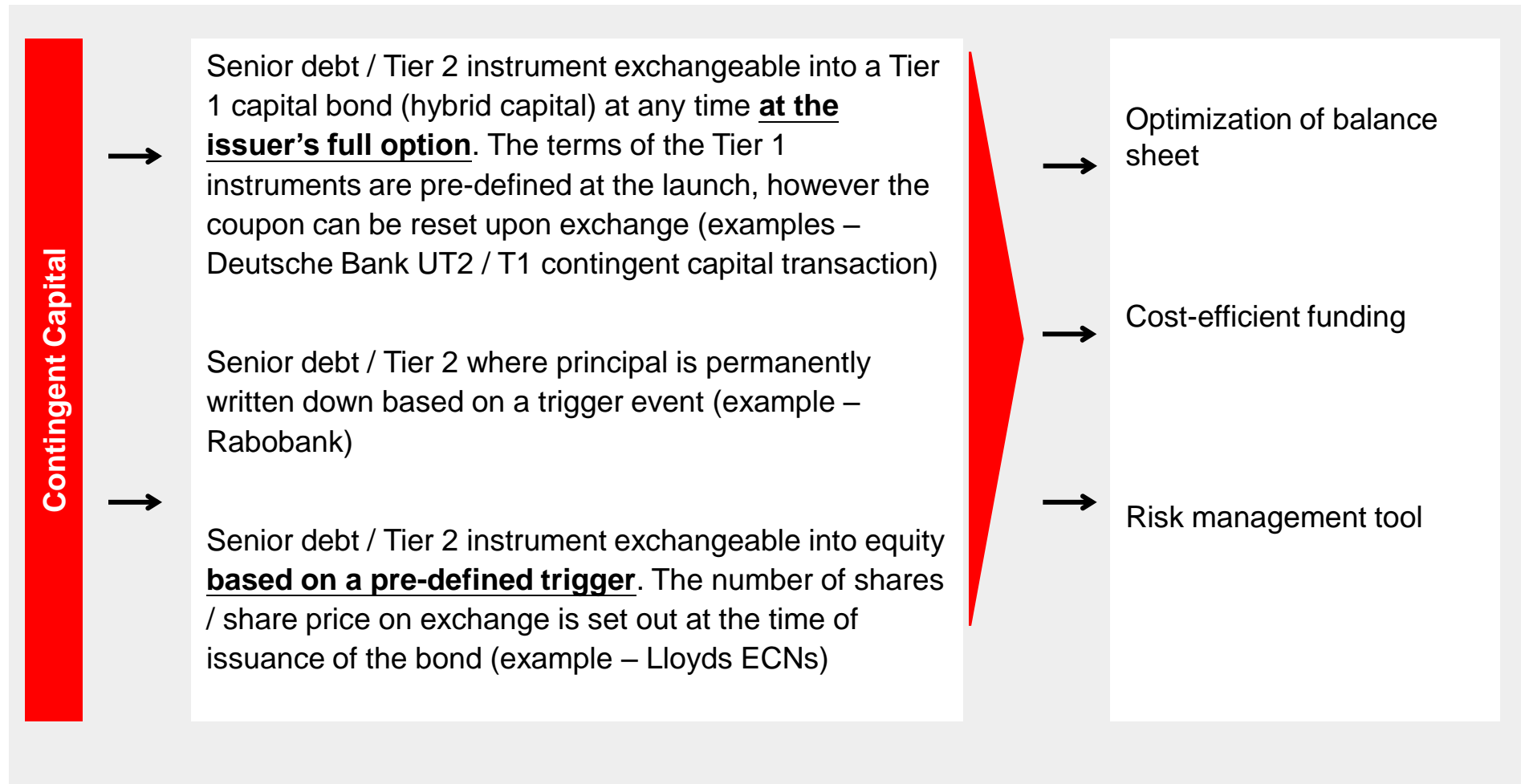
- Basel review has also identified the merits of contingent capital
- Switzerland, Canada and the UK are big proponents of contingent capital as a useful tool to re-capitalise banks in any future financial crisis
- The Swiss proposals consider the use of contingent capital for up to 9% of RWAs
- The Basel Committee will consult further on contingent capital before July 2011

What is  
Contingent  
Capital?

- An instrument that can be converted into a higher form of capital (or equity)
- It allows an issuer to pre-secure higher quality regulatory capital for a future date and to avoid execution uncertainty
- Can be generated by e.g. issuing a senior or subordinated bond which embeds a conversion option into a higher tier of capital (often equity)

# Forms of Contingent Capital

## Examples of structuring alternatives



Q & A

# Disclaimer

The Hongkong and Shanghai Banking Corporation Limited (“HSBC”) has prepared this document (the “Document”) for information purposes only. This Document does not constitute a commitment to underwrite or purchase or subscribe for all or any portion of the securities mentioned herein. Any such commitment shall be evidenced only by a fully executed subscription agreement, purchase agreement or similar contractual document. This Document should also not be construed as an offer for sale of or subscription for any investment, nor is it calculated to invite/solicit any offer to purchase or subscribe for any investment.

HSBC has based this Document on information obtained from sources it believes to be reliable but which it has not independently verified. HSBC makes no guarantee, representation or warranty and accepts no responsibility or liability for the contents of this Document and/or as to its accuracy or completeness and expressly disclaims any liability whatsoever for any loss howsoever arising from or in reliance upon the whole or any part of the contents of this Document. HSBC and its affiliates and/or its or their respective officers, directors and employees may have positions in any securities mentioned in this Document (or in any related investment) and may from time to time add to or dispose of any such securities (or investment). HSBC and/or any of its affiliates may act as market maker or have assumed an underwriting commitment in the securities of any companies discussed in this Document (or in related investments), may sell them to or buy them from clients on a principal or discretionary basis and may also perform or seek to perform banking or underwriting services for or relating to those companies. As HSBC is part of a large global financial services organisation, it or one or more of its affiliates may have certain other relationships with the parties relevant to the proposed activities as set out in this Document, and these proposed activities may give rise to a conflict of interest, which the addressee hereby acknowledges.

No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. This Document, which is not for public circulation, must not be copied, transferred or the content disclosed to any third party and is not intended for use by any person other than the addressee or the addressee's professional advisers for the purposes of advising the addressee hereon.

## **The Hongkong and Shanghai Banking Corporation Limited**

Level 16 HSBC Main Building

1 Queen's Road Central

Hong Kong SAR

© Copyright. The Hongkong and Shanghai Banking Corporation Limited 2010, ALL RIGHTS RESERVED. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of The Hongkong and Shanghai Banking Corporation Limited.