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Structured Finance

Basel III and Solvency II: issues for the ABS market and the real economy

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Background

In its current form, the global regulatory response to the financial crisis looks set to result in a significant contraction of bank and insurance liquidity from the global private credit markets with a distortion of liquidity towards sovereign paper, as well as an overall contraction of liquidity going into the real economy.

Basel III is being implemented in Europe via a new Capital Requirements Directive and a new Capital Requirements Regulation (together, "CRD IV"). CRD IV provides a new regime regulating, *inter alia*: (i) quantity of capital; (ii) quality of capital; and (iii) liquidity. The latest draft of CRD IV was published on 21 May 2012 ("Draft CRD IV").

The most significant change for the banking industry is the increase in minimum regulatory capital from 8% under Basel II to 16% or more for Systemically Important Financial Institutions ("SIFIs") under Draft CRD IV - indeed the Commission has been advocating for the floor to be raised to as high as 23% for the biggest SIFIs. The quality of capital is also improving (the higher the quality, the more expensive it is) with the constituent element of Tier 2 capital¹ being capped at 2% (cf 4% under Basel II).

The new liquidity buffer regime adds salt to the wound by imposing further downward ROE pressure on banks and will result in significant asset re-allocation, a trend which will be further exacerbated by the new Solvency II regime which is being imposed on the insurance industry; it seems that the regulators in Europe are keen on banks buying EU sovereign paper and less keen on them putting liquidity into the private credit markets.

Shadow banking will pick up some of the slack but unless there is further revision, the global banking industry will struggle to provide the required level of liquidity to the real economy on an economic/solvent basis² - unless the new paradigm is for central bankers to provide that liquidity *ad infinitum*.

These issues will be felt in the ABS markets, though the recent apparent concession of including prime RMBS in the new bank liquidity buffers required under Basel III provides some encouragement that regulators are aware of the important role which ABS plays in providing bank funding and putting liquidity into the real economy.

¹ One of the principal differences between Tier 1 capital and Tier 2 capital is that instruments comprising the former must be perpetual while Tier 2 instruments may have stated maturity dates provided they are issued with a minimum 5 year term.

² Fitch published a paper on 17 May 2012 (Basel III: Return and Deleveraging Pressures) which indicates that the 29 leading global banks need to raise approximately \$556 billion of new equity or reduce their assets by approximately \$5.5 trillion by 31 December 2018 in order to satisfy the new capital requirements imposed by Basel III. These numbers are based on an assumed Basel III Tier 1 minimum requirement of 10%; SIFIs may in fact face minimum capital requirements of 16% or more under the latest draft CRD IV proposals while the Commission is advocating 23% for the biggest SIFIs.

ABS and the Liquidity Buffers

Liquidity Coverage Ratio

The new Liquidity Coverage Ratio ("LCR") will require banks to maintain a pool of highly liquid assets sufficient to meet cash outflows over a 30 day horizon.

Banks will be required to maintain a minimum LCR of at least 100% in normal times but during periods of stress - when banks are expected to use their pool of liquid assets - they may be allowed to temporarily fall below this level.

Under the LCR, banks will be subject to a hypothetical stress scenario which includes both systemic and institution-specific shocks and assumptions affecting how quickly cash will flow out of the bank's asset pool.

The stress scenario assumes:

- a downgrade of the bank's credit rating
- a partial loss of deposits
- a loss of unsecured wholesale funding
- an increase in secured funding haircuts
- increases in derivative collateral calls
- calls on off-balance sheet exposures

The LCR will increase the proportion of banks' balance sheets comprising highly liquid assets which will put additional pressure on bank funding.

The current draft wording of Article 404 (*Reporting on liquid assets*) of the Capital Requirements Regulation (the "CRR") provides that the following qualify as liquid assets:

- cash
- central bank deposits
- sovereign paper
- other assets of "high liquidity and credit quality"

Assets may be classified as of "high liquidity and credit quality" when they:

- are central bank eligible
- have an easily determinable price
- are listed on a recognised exchange
- have an active private sector repo market
- do not comprise own-issuance

The European Banking Authority ("EBA") has been tasked with defining "high liquidity and credit quality" for the purposes of Article 404 CRR.

In formulating the meaning of "high liquidity and credit quality", Article 481 (*Liquidity requirements*) of the CRR requires the EBA to consider including "[i] RMBS of high liquid and credit quality, (ii) other categories of central bank eligible assets, for example local government bonds, and (iii) other non-central bank eligible but tradable assets, for example equities listed on a recognised exchange and gold."

More generally, in determining what makes an asset of high liquidity and credit quality, the EBA is expected to consider:

- trade volumes
- outstanding volumes
- transparency of pricing and post-trade information
- credit quality
- price stability

- maximum bid / ask spread
- remaining time to maturity
- turnover ratio

In a move to assist the regulators in identifying what categories of ABS might properly be regarded as being of *high liquidity and credit quality*, The Association of Financial Markets in Europe ("AFME") has endorsed the establishment of the Prime Collateral Securities Scheme (the "PCS Scheme") which will provide a kite-marking system for ABS. The PCS Scheme will certify the transparency, quality and standardisation of certain features of high-grade ABS which market participants hope will allow regulators to easily identify a category of securitisations that may then be eligible for LCR and Solvency II benefits. The initiative has received support from the Commission, the EBA and the European Central Bank ("ECB").

The PCS Scheme is intended to start in May 2012, with AFME intending to unveil the standards by the end of the second quarter of 2013 and to see the first issuance with the stamp of approval by the third quarter. Weil, Gotshal & Manges is a founder participant of the PCS Scheme.

Net Stable Funding Ratio ("NSFR")

Basel III will also introduce a second liquidity minimum standard, the NSFR, which will look at a bank's potential liquidity requirements over a one year horizon. This ratio is intended to prevent banks once again becoming over-reliant on short-term wholesale funding markets. The NSFR requires that "stable funding" (equity, deposits and long term debt) divided by "weighted long term assets" must be > 100%.

Capital Requirements

Minimum Capital Requirement

Whilst the Minimum Capital Requirement ("MCR") remains at 8% of risk-weighted assets ("RWAs"), the minimum ratios for common equity Tier 1 capital ("CET1") and total Tier 1 capital will increase to 4.5% and 6% respectively while the constituent element of Tier 2 capital falls from 4% to 2%. The MCR of 8% therefore consists of the following:

- 4.5% CET1
- 1.5% Additional Tier 1
- 2% Tier 2

Capital Conservation Buffer

The Capital Conservation Buffer (the "Conservation Buffer") requires banks to hold an additional 2.5% of CET1. Where institutions suffer losses which result in their CET1 dipping below 7% (i.e. CET1 element of the MCR plus the Conservation Buffer) they will be subject to certain restrictions, including restrictions on making dividend payments.

Countercyclical Capital Buffer

The Countercyclical Capital Buffer (the "Countercyclical Buffer") will provide additional CET1 to absorb losses following periods of excessive credit growth. The buffer will be fixed at the discretion of individual national regulators up to an additional 2.5%. Where economic growth is slowing, regulators may allow banks to reduce this buffer thereby enabling banks to effectively put more liquidity into the system during a downturn. The Countercyclical Buffer taken together with the Conservation Buffer and the MCR point to a minimum required capital ratio of 13%.

Systemic Risk Buffer

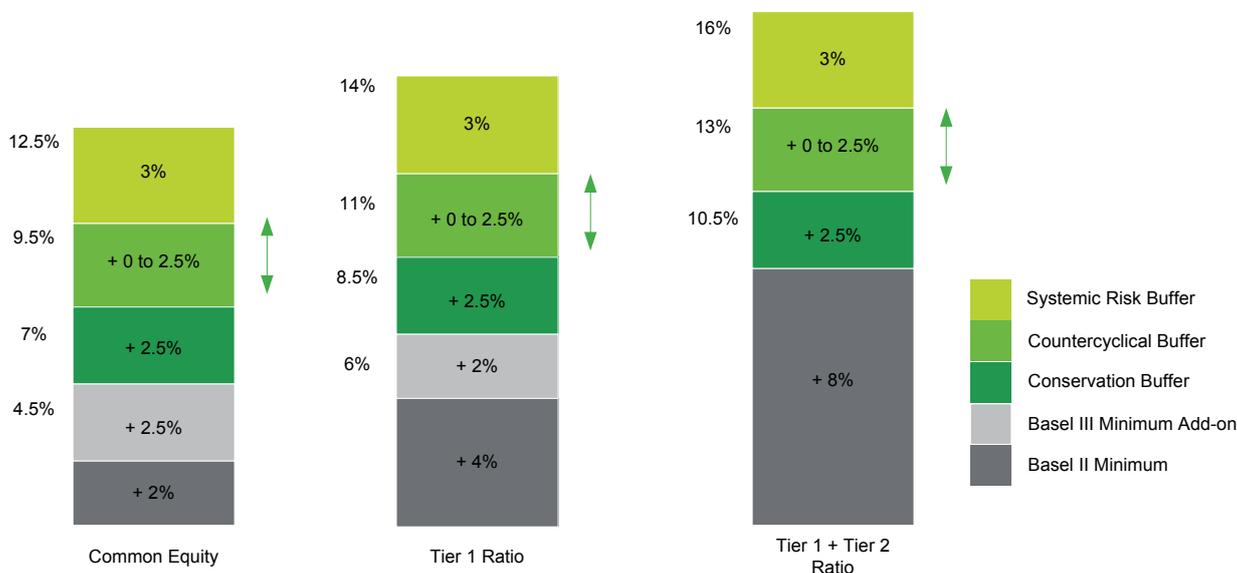
The Draft CRD IV introduces a third additional CET1 buffer, the Systemic Risk Buffer ("SRB"). Article 124a (*Requirement to maintain a Systemic Risk Buffer*) of the Draft CRD IV provides that Member States may unilaterally impose an additional 3% CET1 requirement either on

a national or institution specific basis to cover systemic risks. Furthermore, SRB's >3% are contemplated and while the drafting is not clear on the point (perhaps due to ongoing negotiations on this issue), it may be that the imposition of SRB's >3% will require Commission consent. Assuming a "normal" SRB of 3%, this when taken together with the MCR, the Conservation Buffer and the Countercyclical Buffer points to a minimum required capital ratio of 16%.

SIFI Buffer

While not included in the Draft CRD IV, the Commission has advocated introducing a SIFI Buffer requiring an *additional* 10% capital made up of the most expensive CET1 which would take the minimum required capital ratio for SIFIs to 23% (on the assumption that it would replace the SRB rather than being in addition to it).

Basel II vs. Basel III Capital Ratios



The Solvency II Directive (2009/138/EC) ("Solvency II")

Solvency II is scheduled to be enacted into law in January 2013 and take effect from 1 January 2014, though certain features will be phased in over a 10 year implementation period.

Under Solvency I there are no explicit capital requirements related to credit risk. Insurers are therefore currently able to invest in equities, real estate, corporate and government bonds of any credit quality or duration without needing to consider any adverse regulatory capital treatment.

Solvency II introduces a risk-based approach to measuring regulatory capital for the insurance industry. To calculate capital charges, insurers can use either the standard formula or an internal model. The standard formula is set out by the regulator for each asset class, while the internal model

is developed by the insurer to better reflect the economic risks underlying its portfolio. Internal models are calibrated based on the insurer's past experience and available market information, meaning that they are likely to result in lower capital charges.

ABS and Solvency II

Solvency II imposes punitive capital charges on ABS compared to covered bonds and corporate bonds (see table below). This will cause insurers to shift out of ABS and into more favourably treated asset classes such as government bonds and shorter-dated corporate bonds.

AFME conducted an investor survey, collecting opinions from 27 European insurance companies and asset managers (who collectively manage > €5 trillion in assets). One-third of insurers polled said that the new Solvency II rules would stop them investing in ABS altogether, with the remaining two-thirds saying that they would dramatically

reduce allocation of funds to the ABS sector. The results of the survey also show that 56% of insurers will be incentivised to develop their own internal models to calculate their own capital charges. However, over half of the respondents surveyed also believe that regulators will not approve their internal models if the results were materially different from those generated by the standardised approach.

Government Bonds and Solvency II

EEA government bonds are not subject to a capital charge under the Solvency II standard formula, regardless of their rating level. It is expected that the returns (in contrast to those on AAA rated ABS), especially on lower-rated sovereign bonds, could be very attractive to insurers upon the implementation of Solvency II. The proposed capital charges for Covered Bonds, ABS and Corporate Bonds are set out below:

Rating Category	AAA	AA	A	BBB	BB	B	Unrated
Covered Bond Capital Charge							
Duration - 1 year	0.7	0.9	1.4	2.5	4.5	7.5	7.5
Duration - 5 years	3.5	4.5	7.0	12.5	22.5	37.5	37.5
Duration - 10 years	6.0	7.0	10.5	20.0	35.0	58.5	58.5
Securitisation Capital Charge							
Duration - 1 year	7	16	19	20	82	100	100
Duration - 5 years	35	80	76	40	82	100	100
Duration - 10 years	42	80	76	40	82	100	100
Corporate Bond Capital Charge							
Duration - 1 year	0.9	1.1	1.4	2.5	4.5	7.5	7.5
Duration - 5 years	4.5	5.5	7.0	12.5	22.5	37.5	37.5
Duration - 10 years	7.1	8.4	10.5	20.0	35.0	58.5	58.5

Annex 1: Phase-in Arrangements

(Shading indicates transition periods and all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
MCR CET1			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Conservation Buffer CET1						0.625%	1.25%	1.875%	2.5%
Countercyclical Buffer CET1						0.625%	1.25%	1.875%	2.5%
MCR CET1 plus Conservation Buffer CET1 and Countercyclical Buffer CET1			3.5%	4.0%	4.5%	5.75%	7.0%	8.25%	9.5%
Minimum Total Tier 1 Capital (excluding Buffers)			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
MCR (including Tier 2 but excluding Buffers)			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
MCR plus Conservation Buffer CET1 and Countercyclical Buffer CET1			8.0%	8.0%	8.0%	9.25%	10.5%	11.75%	13%
SRB CET1									3% ³
Total Capital									16%

Liquidity Coverage Ratio	observation period begins				Introduce minimum standard				
Net Stable Funding Ratio		observation period begins						Introduce minimum standard	

³ No details are available yet as to the timing of implementation of the SRB.

If you would like more information about Basel III and Solvency II: issues for the ABS market and the real economy or Weil's Structured Finance Group, please speak to your regular contact at Weil, or contact:

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