Implementing Basel II/III in Russia
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In the wake of the financial crisis and the large losses observed in the financial industry and the subsequent intervention by central banks and governments to bail out failed banks, the Basel Committee on Banking Supervision (BCBS) amended and strengthened the global capital framework known as the Basel Accord.

The Implementation of the Basel Capital Adequacy Framework (Basel II, Basel II.5 and Basel III) in Russia will require Russian Banks to further develop their Capital and Risk Management methodologies, systems and processes. Whereas European countries have been working continuously on implementation of these regulatory standards for more than 10 years, the Russian financial institutions face the challenge of implementing the three elements of the Basel Accord simultaneously.

The Central Bank of Russia (CBR) has already adapted several elements of Basel II, e.g., Simplified Standardized Approach for Credit Risk, Simplified Approach for Market Risk or Basic Indicator Approach for operational risk. The requirements regarding Pillar II and Pillar III will be implemented not earlier than 2014 and 2013, respectively.

What are the specifics of the Russian adoption of the Basel Accords? How will these regulatory initiatives impact the Russian financial industry? What are the main consequences of the changes in the regulatory environment? How will the Russian financial industry respond to these challenges?

This brochure aims to provide the answers to some of these questions.

* Starts: 1 February 2013 (Regulation as of 28.9.2012 No. 387-P)
Implementing Basel II/III in Russia

The integration of the Basel Accords into the Russian regulatory framework will have several specifics:

• It should be noted that the final formulation of the application of Basel II/III into Russian regulation is not yet complete.
• Russian financial institutions face the challenge of implementing all the 3 developments of the Basel Accord (Basel II, Basel 2.5 and Basel III) simultaneously, whereas European countries have been working continuously on implementation of these regulatory standards for more than 10 years.
• CBR is stricter than the Basel Committee in several areas, e.g., current capital adequacy ratios applied by CBR are 25% higher or treatment of subordinated debt. However, the requirements for Capital Conservation Buffer and Countercyclical Buffer have not yet been confirmed by CBR. Furthermore, Basel III excludes preferred shares from Common Equity Tier 1 Capital (CET1), but the CBR permits to include certain types of preferred shares into CET1.
• Additionally, there are severe liquidity requirements in the form of 3 liquidity ratios in Russia, which are comparable with Basel III liquidity ratios to a certain extent.
• The CBR has already adapted several elements of Basel II, for instance, Simplified Standardized Approach for Credit risk, Simplified Approach for Market risk or Basic Indicator Approach for Operational Risk. Pillar II and Pillar III will be implemented not earlier than 2014 and 2013 respectively.

To what extent a bank is affected by the new Basel requirements depends on a variety of factors, e.g., its business model and strategy, the current capital and liquidity composition and levels, the credit quality of its counterparties and the extent of its off-balance-sheet activities. An adverse impact on profitability, caused by higher cost of capital and liquidity and additional regulatory cost, is expected for the banking system as a whole.

Executive summary

**Benefits**

- More robust banking system in potential downturns
- Reduced procyclicality
- Reduced vulnerability to liquidity shocks
- Improved credit portfolio quality
- Improved corporate governance and risk management
- Better transparency for capital markets
Basel III around the globe and in Russia

In 2010 the Basel Committee on Banking Supervision (BCBS) introduced the Third Basel Accord that became a cornerstone in regulatory risk and capital management of financial institutions. It sets new minimum capital requirements, new liquidity and leverage ratios, new risk measurement techniques and approaches. Additionally, it establishes stronger standards for supervision, public disclosures and risk management.

The Basel Committee established a rather extensive timeline for the banks to adopt the necessary requirements of Basel III, so different components of the Accord have their particular deadlines and time frames for implementation. The initial intention was that certain rules must come into force on 1 January 2013.

Implementation timetables differ by country. Currently, countries that intend to implement Basel III can be divided into two groups:

I. Australia, China, Hong Kong SAR, India, Japan*, Canada, Mexico, Saudi-Arabia, Switzerland, Singapore and South Africa published their final rules in 2012, so they started implementing Basel III in January 2013.

II. Argentina, Brazil, Indonesia, Russia, South Korea, the United States and the European Union published first drafts of the regulation in 2012. In EU, several amendments to the capital framework have already been implemented through the CRD II, CRD III and CRD IV. However, in the last announcements, the US and EU communicated their plans to postpone the implementation of Basel III.

In Russia, the draft regulations for capital definition and capital adequacy ratios within the Basel III framework were published for public consultation in September 2012. CBR announced the capital calculation requirement in accordance with the Basel III framework to start from October 2013. To ensure a smoother transition period, CBR requires parallel calculation of capital ratios starting from April 2013.

Additionally, CBR plans to introduce the calculation of the Leverage Ratio, starting with a parallel run from 2013-2017, and starting disclosure of the ratios in 2015. In 2018 the Leverage Ratio will be included in the list of mandatory regulatory ratios.

In terms of the liquidity framework, the Liquidity Coverage Ratio (LCR) will be mandatory from January 2015, and the Net Stable Funding Ratio (NSFR) is supposed to be implemented in January 2018.

Further Basel III topics, such as mandatory capital conservation buffer, discretionary countercyclical buffer, counterparty risk calculation, etc. are currently being assessed and discussed by CBR.

The time frame for implementation of different standards is shown in Appendix 1.

* Full implementation in Japan starts at the end of March 2013. Japan does not comply with the capital buffer requirement at the moment but plans to publish corresponding internal regulatory requirements in 2015, one year ahead of the Basel III schedule for implementation.

Turkey will issue draft regulations early in 2013
Basel III: what is new?

In particular, the framework focuses on the quality and quantity of capital that financial institutions are required to hold. Of particular importance is the implementation of increased Common Equity Tier1 (CET1) and Tier 1 minimum Capital ratios to ensure that banks hold enough high-quality, loss-absorbing capital. This is followed by much stricter definitions of eligible capital and additional capital buffers (a 2.5% capital conservation buffer and a countercyclical capital buffer varying between 0 and 2.5%). The capital conservation buffers should be built up in good times in order to be drawn upon in periods of financial distress. The countercyclical buffer can be introduced by the national regulator in times of excessive credit growth.

In terms of liquidity, the new global minimum standards were introduced to improve banks’ resilience in a liquidity crisis. All liquidity requirements can be grouped into short-term funding (Liquidity Coverage Ratio, LCR), long-term funding (Net Stable Funding Ratio, NSFR) and additional reporting and qualitative requirements. The former implies that the banks should have sufficient high-quality, liquid and unencumbered assets in order to survive a significant stress scenario of cash-outflows, specified by the supervisor, and lasting for one month. The second requirement intends to promote longer-term structural funding by requiring that the ratio of available stable funding to required stable funding exceeds 100% over a one-year time horizon. Finally, new reporting requirements comprise contractual cash flow mismatch reporting, concentration of funding reporting and available unencumbered assets reporting.

Basel II.5 introduces significantly higher capital requirements in the area of market risk for banks using internal models. Basel III continues to define minimum capital ratios related to Risk Weighted Assets (RWA).

Current developments attempt to lower the drawbacks that were identified in Basel II. In particular, the framework addresses the following aspects:

- New capital charge to cover CVA volatility
- New charge for exposures to central counterparties
- Higher quantitative requirements primarily for firms that have Internal Model Method (IMM) approval
- Higher qualitative requirements

Finally, Basel III introduces a so-called Leverage Ratio to restrain banks from excessive on- and off-balance-sheet leverage, i.e., in parallel to the minimum capital ratios, banks are required to hold a minimum amount of Tier 1 capital in relation to their total on- and off-balance sheet exposures.
Overview on Basel regulations in Russia

CBR has published a set of different documents related to the implementation of the Basel Accord in Russia:

<table>
<thead>
<tr>
<th>Topic</th>
<th>CBR document</th>
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<tbody>
<tr>
<td><strong>Basel III</strong></td>
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<tr>
<td>Overall implementation of Basel Accord</td>
<td>“Strategy of the bank sector development till 2015” (January 2011)</td>
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<tr>
<td>Capital adequacy</td>
<td>Regulations on the methodology for defining the value and on the estimate of sufficiency of the own funds (capital) of credit institutions (Basel III) N395-P”; (December 2012)</td>
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<tr>
<td>Liquidity adequacy</td>
<td>“Strategy of the bank sector development till 2015” (January 2011)</td>
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<tr>
<td>Leverage ratio</td>
<td>“Strategy of the bank sector development till 2015” (January 2011)</td>
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<tr>
<td>Stress testing</td>
<td>“Methodological recommendations to financial recovery plans N193-T” (December 2012)</td>
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<td><strong>Basel II</strong></td>
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<td>Credit IRB approach</td>
<td>“Guidelines for measurement of credit risk on the basis of internal rating models N192-T” (January 2013)</td>
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<td>Market risk</td>
<td>“Regulation on market risk assessment N387-P” (September 2012)</td>
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<tr>
<td>Operational risk</td>
<td>“Regulation on operational risk calculation N346-P” (November 2009)</td>
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<td></td>
<td>“Principles of the Sound Management of Operational Risk N69-T” (May 2012)</td>
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<td>Pillar II/ICAAP</td>
<td>“Methodological recommendations to ICAAP N96-T” (June 2011)</td>
</tr>
<tr>
<td>Compensation system</td>
<td>“Direction on estimating Bank’s economic position 2894-U” (October 2012)</td>
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<td></td>
<td>“Methods of compensation remuneration in accordance with risks and performance results 38-T” (March 2012)</td>
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The preliminary time frame for implementation of different Basel standards in Russia is shown in Appendix 2.
Integration of Basel Accord into the Russian regulatory framework

Basel III: capital adequacy

- Currently, CBR Instruction N139-I regulates the minimum capital adequacy ratio (N1) of 10%.
- With regard to Basel III implementation, CBR issued drafts of new documents which propose to calculate three capital adequacy ratios, starting from April 2013:

<table>
<thead>
<tr>
<th>CBR capital ratios</th>
<th>Basel III capital ratios</th>
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</thead>
<tbody>
<tr>
<td>- Core Capital Adequacy Ratio (N1.1) ≥ 5.6%</td>
<td>- Common Equity Tier 1 Ratio ≥ 4.5%</td>
</tr>
<tr>
<td>- Main Capital Adequacy Ratio (N1.2) ≥ 7.5%</td>
<td>- Tier 1 Ratio ≥ 6.0%</td>
</tr>
<tr>
<td>- Total Own Capital Adequacy Ratio (N1.0) ≥ 10%</td>
<td>- Total Capital Ratio ≥ 8.0%</td>
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<td></td>
<td>- Countercyclical Buffer ≥ 2.5 %</td>
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<td></td>
<td>- Capital Conservation Buffer ≥ 2.5 %</td>
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- The CBR ratios are approximately 25% higher than Basel III requirements. However, the ratios for Capital Conservation Buffer and Countercyclical Buffers have not yet been confirmed by CBR.

- The current composition of available regulatory capital is stated in CBR Direction N215-P.
- In the context of Basel III framework, CBR issued drafts of new documents which propose the following:
  - To split the Main Capital into Core and Additional Capital
  - To increase requirements for subordinated debts and preferred stocks: (1) ‘new’ subordinated debt must be convertible into ordinary shares; (2) ‘old’ subordinated debt must be amortized within the next 10 years (10% annually)**
  - To include “perpetual subordinated debt” into Additional Capital
  - To introduce higher coefficients, i.e., 2.5 and 10 for investments in affiliated companies
- The CBR adoption of Basel III requirements has several specifics:
  - While Basel III excludes preferred shares from Common Equity Tier 1 Capital, the CBR permits the inclusion of certain types of preferred shares into Core Capital
  - Certain types of subordinated debt and preferred stocks should be amortized within 10 years (10% annually) according to CBR**

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* As sum of Main Capital and Supplementary Capital
** There are 2 different dates in discussion ‘1 January 2013’ and ‘1 May 2013’
Basel III: Liquidity and Leverage Ratio

**Liquidity ratios**

- CBR Instruction N139-I governs the current liquidity adequacy ratios. However, CBR published “Strategy of banking sector development till 2015” in January 2011, which announced the following new liquidity ratios:

<table>
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<tr>
<th>Current CBR liquidity ratios</th>
<th>New Basel III liquidity ratios</th>
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<tbody>
<tr>
<td>Instant Liquidity Ratio (N2) ≥ 15%</td>
<td>Liquidity Coverage Ratio (LCR) ≥ 100%</td>
</tr>
<tr>
<td>Current Liquidity Ratio (N3) ≥ 50%</td>
<td>Net Stable Funding Ratio (NSFR) &gt; 100%</td>
</tr>
<tr>
<td>Long Term Liquidity Ratio (N4) ≤ 120%</td>
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- The Basel LCR requires a higher quality of liquid assets. Additionally, the minimum ratio set by the Basel Committee is higher, taking into account the same base of calculation.
- The Basel NSFR requires a higher percentage rate and includes more asset categories.
- Starting from January 2015, LCR compounding as a liquidity ratio will be mandatory, whereas NSFR will become mandatory only in January 2018.

**Leverage ratio**

- Currently, regulatory Leverage Ratio in Russia is mentioned only in the “Strategy of banking sector development till 2015” issued in January 2011. There are not any further official documents dealing with this topic.
- CBR plans to introduce the calculation of Leverage Ratio from 2013 to 2017, in a parallel run, with disclosure starting from 2015; in 2018 the Leverage ratio will be included in the list of mandatory regulatory ratios.
CBR announced the new regulation N193-T “Methodological recommendations on development of recovery plans in credit institutions“ in 2012, which requires Russian banks to develop recovery plans under stress conditions. The main purpose is to ensure capital and liquidity adequacy under these stress conditions without any support from CBR.

The document is based on the Financial Stability Board (FSB) document “Key Attributes of Effective Resolution Regimes for Financial Institutions” and focusing on the following areas:

- Conditions of recovery plan development
- Structure of recovery plans
- Scenarios to be implemented
- Early warning indicators

The base stress scenario recommended by CBR contains the following conditions:

- 1.5% decline in Russian GDP
- 30-50% drop in Russian stock market indices
- Sharp increase in yields on government (200-300 bp) and corporate (500-1000 bp) bonds
- 20-30% deterioration rate of the currency basket

The banks must develop contingency plans related to capital and liquidity under these stress conditions. The support of CBR must not be considered. The financial aid provided by CBR will be included if necessary in the recovery plans of the banks that are systematically important for the Russian banking system. These support plans will be developed by CBR itself and these plans will be strictly confidential.

Besides preparation of recovery plans, CBR recommends developing systems of early warning indicators, for instance, persistent decline of capital adequacy ratio, persistent substantial growth of problem loan fraction of credit portfolio, persistent client run-off and substantial decline of credit rating.
Basel II: Credit IRB Approach

The CBR published “Guidelines to measure credit risk on the basis of internal rating models N192-T” to describe the requirements for banks that intend to apply for the certification of their Internal Rating models under Basel II IRB Approaches. The adoption of IRB Approaches will most likely be possible as of 2015. Currently, capital requirement for credit risk is calculated according to CBR instruction N139-I and further documents.

The IRB Approach is an alternative to the Standardized Approach to define capital requirement for credit risk. The Standardized Approach uses fixed risk weights for different asset types that are defined by the regulator, whereas the IRB Approach allows banks to use their internal rating systems to define the risk weights.

Risk weighted assets (RWA) that are calculated on the basis of internal estimations of probability of default (PD), loss given default (LGD) and exposure at default (EAD) will be included in the denominator of the formula of minimum capital requirements (N139-I).

To be qualified to use the IRB Approach for credit risk estimation, a bank must demonstrate that it has been using an internal rating system in internal processes of credit risk management for at least three years. A bank must produce an implementation plan, specifying to what extent and when it intends to roll out IRB Approaches across its asset classes and business units over time.

To calculate capital requirements on the basis of the IRB Approach a bank must meet certain minimum requirements, such as segmentation of banking book assets into seven regulatory-defined categories, be in compliance with the regulatory definition of default, minimum data history to estimate PD’s, LGD’s and EAD’s, etc.

The CBR permits the use of one of the two potential IRB Approaches: foundation or advanced. Under the Foundation Approach (F-IRB), as a general rule, banks provide their own estimates of PD and rely on supervisory estimates for other risk components. Under the Advanced Approach (A-IRB), banks have to provide their own estimates of PD, LGD and EAD, and their own calculation of Maturity. For retail exposures, banks must provide their own estimates of PD, LGD and EAD even when applying the F-IRB.

The term “rating system” comprises all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates.

Within each asset class, a bank may utilize multiple rating methodologies/systems. If a bank chooses to use multiple methodologies, the rationale for assigning a borrower to a particular rating system must be documented and applied in a manner that best reflects the level of risk of the borrower.

The CBR describes the following minimum requirements for rating models:

- Model must have good predictive power. Banks must regularly compare realized default rates with estimated PDs for each grade and be able to demonstrate that the realized default rates are within the expected range for that grade.
- Variables that are entered into the model must form a reasonable set of predictors.
- There must be no known material biases.
- Banks must have a process in place for vetting data inputs into a statistical default or loss prediction model which includes an assessment of the accuracy, completeness and appropriateness of the data specific to the assignment of an approved rating.
- Banks must demonstrate that the data used to build the model are representative of the population of the bank's actual borrowers or facilities.
- Banks must have a regular cycle of model validation that includes monitoring model performance and stability, review of model relationships and testing model outputs against outcomes.
- Banks may combine model results with human judgment.
- Banks may have procedures for human review of model-based rating assignments. Such procedures should focus on finding and limiting errors associated with known model weaknesses and must also include credible ongoing efforts to improve the model's performance.

Internal rating models have to be certified by CBR through a rather extensive waiver application process. Compared to the Standardized Approach for credit risk, banks applying for the IRB Approach may lower their capital requirement for credit risk significantly. Nevertheless, implementing the IRB Approach requires considerable investments in the development of these internal rating models.
Basel II: market risk

The CBR regulations in the field of market risk N387-P/N372-P prescribe the calculation of market risk using the Standardized Approach. The adoption of the Internal Model Approach for market risk is not planned for the near future. The results of the calculation are included in the capital adequacy ratio regulated by N139-I.

Whereas regulation N387-P focuses on interest rate risk and equity risk for trading and available for sale instruments, the risk of derivatives is regulated by N372-P. Additionally, FX risk and commodity risk are regulated by CBR instruction N124-I.

The new CBR document N387-P is seen as a step towards Basel II Standardized Approach for market risk due to adjustments made in the formula for calculation of market risk (coefficient 12.5 instead of 10 has been introduced, which is aligned to the Basel II minimum requirement of 8%).

Market risk exposure for trading book positions is estimated in the following way:

\[ MR = 12.5 \times (IR + ER) + FX \]


FX risk and commodity risk are equal to the sum of open currency and commodity positions. They are included in the market risk calculation if FX as a percentage of equity (capital) is larger than 2%.

Interest rate risk is calculated as the sum of specific and general market risk. Specific risk is the risk of adverse movement in the price of an individual security owing to factors related to the individual issuer. General risk is the risk of loss arising from changes in market interest rates. The Specific risk coefficient of a security depends on the credit quality of the security. The general risk measure is the weighted sum of interest rate positions. The weight reflects the price sensitivity of the position to assumed changes in interest rates (lower weight corresponds to lower maturity).

Equity risk is calculated as the sum of specific risk and general risk. Specific risk is defined as the bank’s gross equity positions (the sum of all long equity positions and of all short equity positions) multiplied by the coefficient 8%. General risk is defined as the difference between the sum of the long and the sum of the short positions multiplied by the coefficient 8%.

For banks using internal model for market risk Basel II.5 introduces significantly higher market risk capital requirements (i.e. 3 to 4 times higher than under Basel II).

Furthermore the Basel Committee has recently published a consultative document “Fundamental Review of the Trading Book” which discusses further changes in the treatment of market risk.
Basel II: operational risk

The CBR regulation in the field of operational risk N346-P prescribes the calculation of operational risk according to the Basic Indicator Approach (BIA) of Basel II Accord. The results of the calculation with coefficient 10 are included in capital adequacy ratio regulated by N139-I. Since August 2012 the banks must include the entire amount of operational risk calculated according to this approach into the capital adequacy ratio (N139-I).

The Basic Indicator Approach allocates operational risk capital using a single indicator as a proxy for an institution’s overall operational risk exposure. Gross income is proposed as the indicator, with each bank holding capital for operational risk equal to the amount of a fixed percentage (15%), multiplied by its individual amount of gross income.

Further Basel II approaches as Standardized Approach or the Advanced Measurement Approach for operational risk are not allowed yet.

Additionally, the CBR distributed the letter N69-T “Principles for the Sound Management of Operational Risk from June 2011” in May 2012, which describes sound principles in the field of operational risk governance, management, monitoring and measurement.
Whereas Pillar I describes the minimum capital requirements for credit, market and operational risks, Pillar II of Basel II provides qualitative requirements with regard to capital adequacy for risk factors not covered by Pillar I.

The CBR provided “Methodological recommendations for organization of the Internal Capital Adequacy Assessment Process (ICAAP) in credit institutions (N96-T)” in June 2011. These recommendations contain minimum standards for the implementation of a sound ICAAP to align total capital of a bank with all the accepted and potential risks incurred by the bank. The CBR recommendations emphasize the following areas:

- ICAAP governance and implementation
- Approaches for risk management organization
- Procedures for planning, allocating and determining capital requirements as well as capital adequacy assessment
- Stress-testing
- Reporting

It also includes recommendations for the assessment of those risks that are not at all or not fully addressed in Pillar I, for instance, interest rate risk in the banking book, liquidity risk, compliance risk, reputational risk and concentration risk.

Further important elements of the ICAAP are topics such as risk aggregation and stress testing. Banks must implement sound capital planning and stress testing processes that allow them to assess whether the capital situation is sufficient to survive even under adverse economic conditions.

The Bank of Russia is taking steps to introduce employee financial motivation risk management into the scope of evaluation of bank management quality. Central Bank Regulation N 2894-U dated 1 October 2012 introduces corresponding amendments to its Regulation “On Bank Economic Position Assessment”.

The changes are scheduled to come into force on 1 July 2013. The assessment of employee financial motivation risk management will be carried out based on the bank’s answers to a series of questions concerning the employee remuneration system and related control procedures established in the bank. The questionnaire specifically focuses on the remuneration of a bank’s executive management and risk-takers, as well as that of employees in the internal control departments. The Bank of Russia’s requirements on appropriate employee financial motivation risk management largely correspond with the Principles for Sound Compensation Practices issued by the Financial Stability Board. In order to comply with the new requirements, banks may need to significantly modify their existing remuneration systems. In particular:

- The amount of incentive payouts should be determined based on the risk profile and profitability metrics of the bank
- For executive management and risk-takers, the portion of variable pay should be no less than 50% of their total compensation
- For employees of internal control departments, the portion of fixed compensation should be no less than 50% of their total compensation
- No less than 40% of variable pay of executive management and risk-takers should be deferred for three years or more, and the bank must be able to reduce or call off this deferred remuneration if, in the course of the deferral period, either the bank or the corresponding business unit reports negative financial results
- Remuneration of executive management and risk-takers should be paid out both in monetary and non-monetary form aligned to the risks and performance of the bank; in the absence of non-monetary remuneration, a portion of the monetary remuneration should be determined based on appreciation of the bank’s share value within a certain period.
Currently, the CBR has not issued any documents related to disclosure requirements (Pillar III). However, these documents are expected in 2014.

According to Basel II and Basel III, financial institutions should have a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including their validity and frequency.

Basel II implies four main groups of disclosures in terms of scope of application, capital structure, capital adequacy and risk exposure and assessment, each of them having qualitative and quantitative requirements. With the development of the Basel III framework, new disclosure requirements were incorporated into Pillar III. These new requirements were developed mainly to add greater specificity to the current requirements. More specifically, Basel III implements remuneration practice disclosures and broadens disclosures on capital structure. The Committee believes that these additional Pillar III requirements on remuneration will support effective market discipline and will allow market participants to assess the quality of the compensation practices and the quality of support for a firm's strategy and risk posture. The requirements have been designed to be sufficiently granular and detailed to allow meaningful assessments by market participants of a bank's compensation practices, while not requiring disclosure of sensitive or confidential information.

Basel II/Basel III: Pillar III

Assessment of the bank's employee financial motivation risk management also focuses on the role of the board of directors (supervisory board) in managing and monitoring the employee remuneration system. It is considered best practice if a specialized body within the board (for example, a remuneration committee) provides recommendations on key issues related to design and operation of the remuneration system in the bank.

The bank should also disclose all relevant information on the remuneration system in a supplementary note to annual reports submitted to the Bank of Russia.

As noted above, these requirements correspond to the international practice of reinforcing control and supervision over remuneration policies and practices in the financial sector. At the same time, direct application of some of the principles indicated in Regulation № 2894-U may not be fully in line with the Russian Labor Code given, for example, the restrictions on the portion of compensation in non-monetary form or absence of explicit regulations on compensation deferral.
How Ernst & Young can help

The challenges involved in implementing Basel into a bank's organization and considering its impact on business are manifold. The alignment of the continuously increasing regulatory requirements with the internal needs for efficient and effective business processes and systems makes the implementation of Basel II and III rather complex. Efforts to work towards a fully fledged and well-adapted solution will not only call for input from risk management, but also several other departments. For example, it will be necessary to consult with representatives of business units, finance & accounting, IT services, data management services, tax, trading operations, etc.

A timely and structured project setup will be crucial in order to identify all areas of activities and aspects to be considered. The challenge lies not only in the complexity of the regulatory requirements, but also in the implementation itself, the impact on business activities, the interaction and coordination of involved parties and the timely allocation of the resources needed. Finally, timely planning, consideration of change requirements and development of strategic alternatives will help a bank secure its position at an early stage of the regulatory change, saving time in reallocation of businesses, assets and funding and the alignment of balance sheet relations.

Given our many years of experience in capital and liquidity management and implementation of regulatory reform projects, coupled with our deep knowledge of the banking industry, Ernst & Young may support you efficiently in all elements of your Basel II/III implementation.

Our solutions include topics such as:
- Basel II/III Awareness Workshops for Senior Management,
- Basel Diagnostic reviews and gap analysis,
- Quantitative Impact Analysis,
- Development/Validation of Internal Rating Models and Overall Risk Management Framework,
- Software Vendor Evaluation and IT-Implementation.

We can assist you on all questions of capital optimization and allocation as well as business and resource planning, etc. Thanks to the involvement of our subject matter experts in all relevant areas of activities, such as risk management, finance & accounting, tax and IT and with our strong background in strategic business and balance sheet planning, our services will be tailored individually to your needs.

Our deep knowledge and encompassing experience dealing with the current Russian regulatory framework combined with our global expertise on Basel Accord implementation allow us to offer you efficient solutions with high business impact.

Ernst & Young's Russian Financial Services Risk Management Group (FSRM) is a dedicated group of risk professionals specializing in financial risk management in Russia and CIS countries. It carefully monitors developments and requirements of the Basel Accord and is in regular dialogue with global and local regulators regarding its implications and implementation. The group cooperates closely with Ernst & Young's Global Financial Services Risk Management organization, a network of more than 1500 Financial Services risk professionals.
### Basel II/III solutions

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Methodology</th>
<th>Organization &amp; Governance</th>
<th>Risk IT</th>
</tr>
</thead>
</table>
| • Cost-benefit analysis of Basel implementation across the bank  
• Impact on business model of the bank and potential adjustments  
• Gap analysis against CBR/Basel requirements  
• Financial/capital planning in response to CBR/Basel requirements  
• Development of Basel implementation plans  
• Roadmap for implementation of CBR standards related to Basel | • Development, implementation and validation of rating scoring systems according to Basel requirements  
• Development and implementation of ICAAP/Pillar II  
• Development of stress testing framework across all risk types  
• Development and implementation of advanced approaches to risk for credit, market and operational risk calculation (portfolio models)  
• Development and implementation of recovery and resolution plans | • Design of target risk organization and governance, including Risk Committee and Credit Risk Committee  
• Development of bank-wide Risk Management Framework, including risk appetite and risk capacity  
• Support in preparation of policies, procedures, methodologies  
• Optimization of governance in the area of Risks and Controls (Operational risk, Internal Audit, Compliance)  
• Efficiency of Risk Management Division | • Development of business requirements for IT risk infrastructure, including rating/scoring models, portfolio models, etc.  
• Development of IT risk architecture according to CBR/Basel requirements  
• IT tests according to regulatory requirements  
• IT implementation of risk systems (rating/scoring, portfolio models) |

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### Your contacts in Moscow

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Mob.: +7 (903) 720 4576  
E-mail: bruno.oppliger@ru.ey.com

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Mob.: +7 (903) 720 8472  
E-mail: vyacheslav.bityutskiy@ru.ey.com
Appendix 1:  
Time frame for implementation of Basel III globally

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>As of 1 January 2019</th>
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<tbody>
<tr>
<td>Minimum Common Equity Tier 1 Ratio</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
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<tr>
<td>Capital Conservation Buffer</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875% 2.5%</td>
</tr>
<tr>
<td>Minimum Common Equity Tier 1 plus capital conservation buffer</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Minimum Tier 1 Capital</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Minimum Total Capital</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Minimum Total Capital plus Conservation buffer</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.5%</td>
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<tr>
<td>Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital</td>
<td>Phased out over 10 year horizon beginning 2013</td>
<td></td>
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<tr>
<td>Phase-in of deductions from CET1 (including amounts exceeding the limit) for DTAs, MSRs and financials</td>
<td>20%*</td>
<td>40%*</td>
<td>60%*</td>
<td>80%*</td>
<td>100%*</td>
<td>100%*</td>
<td>100%*</td>
</tr>
<tr>
<td>Liquidity Coverage Ratio</td>
<td>Observation period</td>
<td>60%*</td>
<td>70%*</td>
<td>80%*</td>
<td>90%*</td>
<td>100%*</td>
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<tr>
<td>Net Stable Funding Ratio</td>
<td>Observation period</td>
<td>Introduce minimum standard</td>
<td></td>
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<tr>
<td>Leverage Ratio</td>
<td>Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015</td>
<td>Migration to Pillar 1</td>
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* percentage of the required adjustments

Source: Basel III: A global regulatory framework for more resilient banks and banking systems
## Appendix 2:
### Time frame for implementation of Basel standards in Russia

<table>
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<tr>
<th></th>
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<td><strong>Basel III</strong></td>
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<td>Minimum Common Equity Tier 1 Ratio (Core Capital)</td>
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<tr>
<td>Capital Conservation Buffer</td>
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<td>0.625%*</td>
<td>1.25%*</td>
<td>1.875%*</td>
<td>2.5%*</td>
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<tr>
<td>Liquidity Coverage Ratio</td>
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<tr>
<td>Net Stable Funding Ratio</td>
<td>Observation period begins</td>
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<td>Mandatory requirement to maintain</td>
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<tr>
<td>Leverage Ratio</td>
<td>Observation period begins</td>
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<td>Parallel run 1 Jan 2013-1 Jan 2017 Disclosure starts 1 Jan 2015</td>
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<td>Market risk</td>
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<td>Operational risk</td>
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</table>

* Details are not confirmed by the CBR

** Implementation for banks with high quality internal database and risk-management system

Source: CBR: Strategy of the bank sector development till 2015