On 12 September 2010, the Group of Governors and Heads of Supervision (the oversight body of the Basel Committee on Banking Supervision – BCBS) announced the calibration and timeline for the package of reforms on the minimum capital requirements and liquidity for banks prior to its submission to the Seoul G20 leaders summit in November.

While much has been said over the possible implications for the industry and economies, it is only after all the calibrations have been published, that banks can begin to see what the final proposals will actually mean for both them and the industry.

In summary, the proposals are:

- The minimum common equity levels are to be increased from 2% to 4.5% (after increased deductions).
- A further 2.5% will need to be held in the capital conservation buffer – or there will be a limit on earnings distribution.
- A further countercyclical buffer of between 0% and 2.5% will be required according to national circumstances.
- These requirements will be supplemented by a non-risk based leverage ratio, which will run in parallel from 2013 to 2018 when it will be become a Pillar 1 requirement.
- The transition period for introduction is long. The deductions will be phased in up to 2018. Non-complying capital instruments will be phased out up to 2023. The new minimum capital ratio comes in by 2015 as well as the liquidity coverage ratio.
- Systemically important banks will likely have to have loss-absorbing capacities beyond the minimums announced. The BCBS and the Financial Stability Board (FSB) are currently working on an approach for such firms, including contingent capital and possible bail in.
- National implementation by member countries will begin on 1 January 2013 and member countries must translate these rules into national laws before this date.

The full requirements will be phased in over time and details are shown in the table overleaf.
Phase-in timetable

Phase-in arrangements (shading indicates transition periods)

*(All dates are as of 1 January)*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum common equity capital 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>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Capital conservation buffer</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum common equity 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>
<td></td>
<td></td>
</tr>
<tr>
<td>Phase in of deductions from CET1 (inc. 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></td>
<td></td>
<td></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>
<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>
<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>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital instruments that no longer qualify as non-core Tier 1 or Tier 2 capital</td>
<td>Phased out over 10-year horizon beginning 2013</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity coverage ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observation period begins</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduce minimum standard</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net stable funding ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observation period begins</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduce minimum standard</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
A few thoughts on the proposals

The long phase in of the requirements is very important to reduce the transitional costs to economic growth. Overall, the package is phased in up to 2019; however, for the phase out of some capital instruments it is 2023. The phase in of the deductions from capital is necessary given the huge effect of deducting most deferred tax assets (DTAs) and many minority interests. The protracted phase out (over a 10-year period starting in 2013) of those capital instruments no longer allowed as non-core Tier1 or Tier2 will also help to reduce the transition effects. The downside effects during the transition period are, however, still very difficult to quantify and the decision to grandfather existing public sector capital injections to January 2018 is important.

In the long term, the costs of meeting these requirements to the banks and the effect on economy, in terms of higher spreads on loans, depends on the rate of return on equity which will be demanded by equity holders on the new higher capital levels. This is one of the big unknowns, and could have a significant impact on the viability of some business models.

Those banks deemed systemically important face the possibility of a further capital surcharge (which is not yet decided), and allowing forms of contingent capital to be used will be important. The fact that the authorities are exploring bail in (i.e., liabilities are haircut to absorb losses for a bank close to failure) is interesting. The issue is the effect it could have on the cost of wholesale liabilities and how any clause would be defined – would it include derivatives?

Running alongside these capital requirements are the separate liquidity requirements. A liquidity coverage ratio is to be introduced from 1 January 2015 with an observation period starting in 2011. It is clear that there will be rigorous reporting of this and the stable funding ratio over the transition period, and banks will have to move quickly to engineer systems and generate data in order to meet these requirements. This combination of liquidity and capital requirements means that some banks will need to review their strategy and funding model. The long observation period and transition to 2018 on the stable funding ratio is important because this will act as another restriction (over and above the leverage ratio) on the size/growth of some types of bank.

Countries have committed to translating the rules into national laws and regulations before January 2013; however, this has implications for EU directives and the timescale is tight regarding the US rule-making process.

Overall, the implications for the banking industry could be profound. These new minimum capital standards changes combined with the higher capital charges for trading books will make some business models less profitable or even unprofitable going forward and banks will need to rethink their strategy and business portfolio in the light of the changes.

Key issues for clients

► With equity capital required to increase by 25%, or more, banks will need to look at ways to optimize the use of their capital.

► Liquidity risk, stress testing and reporting are a huge departure for many banks. Legacy systems and data may create significant issues for many banks.

► The changes will pose strategic challenges for some banks – as the cost of capital increases some business models may no longer be profitable. Restructuring and disposals could increase for some business types and there could be the need to restructure some groups.

► The deferred tax assets change and the new capital instruments will have significant tax implications.
The bar is now set – Basel III

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unswerving commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com

This news release has been issued by EYGM Limited, a member of the global Ernst & Young organization that also does not provide any services to clients.

For more information on the topics and issues raised in this document and how they may affect your organization please visit www.ey.com or contact:

Patricia Jackson  
+44 (0)20 7951 7564  
pjackson@uk.ey.com

John Liver  
+44 (0)20 7951 0843  
jliver1@uk.ey.com

Marie-Laure Delarue  
+33 (0)1 46 93 73 21  
amarie-laure.delarue@fr.ey.com

Bruno Oppliger  
+41 58 286 4667  
bruno.oppliger@ch.ey.com

Giuseppe Quaglia  
+39 (0)27 221 2429  
giuseppe.quaglia@it.ey.com

Nico Warmer  
+31 (0)88 40 71400  
nico.warmer@nl.ey.com

Max Weber  
+49 (711) 9881 15494  
max.weber@de.ey.com

Christophe Wintgens  
+352 42 124 8402  
christophe.wintgens@it.ey.com