MOODY'S ANALYTICS

Basel III Capital and Liquidity Standards - FAQs

1. What are the Basel III capital and liquidity standards?

Compared to the earlier Basel I and II frameworks, Basel III proposes many additional capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and additional capital buffers require banks to hold more capital, and higher quality of capital, than under the earlier Basel II rules. The leverage ratio introduces a non-risk based measure to supplement the risk-based minimum capital requirements. The liquidity ratios ensure that adequate funding is available during periods of stress.

Basel III strengthens the three Basel II pillars, especially pillar 1 with enhanced minimum capital and liquidity requirements

2. What are the key elements of the new regulations?

The new regulations raise the quality, consistency and transparency of the capital base and strengthen the risk coverage of the capital framework. The major elements of the proposals are noted below.

REGULATORY ELEMENT	PROPOSED REQUIREMENT
Higher Minimum Tier 1 Capital Requirement	» Tier 1 Capital Ratio: increases from 4% to 6% » The ratio is set at 4.5% from 1 January 2013, 5.5% from 1 January 2014 and 6% from 1 January 2015 » Predominance of common equity will now reach 82.3% of Tier 1 capital, inclusive of capital conservation buffer
Capital Conservation Buffer	» Used to absorb losses during periods of financial and economic stress » Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirement to 7% (4.5% common equity requirement and the 2.5% capital conservation buffer) in 2013 » The capital conservation buffer must be met exclusively with common equity » Banks that do not maintain the capital conservation buffer will face restrictions on payouts of dividends, share buybacks and bonuses
Countercyclical Capital Buffer	» A countercyclical buffer within a range of 0% - 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances » When in effect, this is an extension to the conservation buffer and so could result in a common equity requirement of as much as 9% in 2013 (4.5% common equity requirement, plus 2.5% capital conservation buffer, plus 2.5%countercyclical capital buffer)

REGULATORY ELEMENT	PROPOSED REQUIREMENT
Higher Minimum Tier 1 Common Equity Requirement	» Tier 1 Common Equity Requirement: increase from 2% to 4.5% » The ratio is set at 3.5% from 1 January 2013, 4% from 1 January 2014 and 4.5% from 1 January 2015
Liquidity Standard	» Liquidity Coverage Ratio (LCR): to ensure that sufficient high quality liquid resources are available for one month survival in case of a stress scenario. Phased introduction from 1 January 2015 » Net Stable Funding Ratio (NSFR): to promote resiliency over longer-term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis » Additional liquidity monitoring metrics focused on maturity mismatch, concentration of funding and available unencumbered assets
Leverage Ratio	» A supplemental 3% non-risk based leverage ratio which serves as a backstop to the measures outlined above » Parallel run between 2013-2017; migration to Pillar 1 from 2018
Minimum Total Capital Ratio	» Remains at 8% » The addition of the capital conservation buffer increases the total amount of capital a bank must hold to 10.5% of risk-weighted assets, of which 8.5% must be tier 1 capital » Tier 2 capital instruments will be harmonized; tier 3 capital will be phased out

Source: Bank for International Settlements, Basel Committee on Banking Supervision.

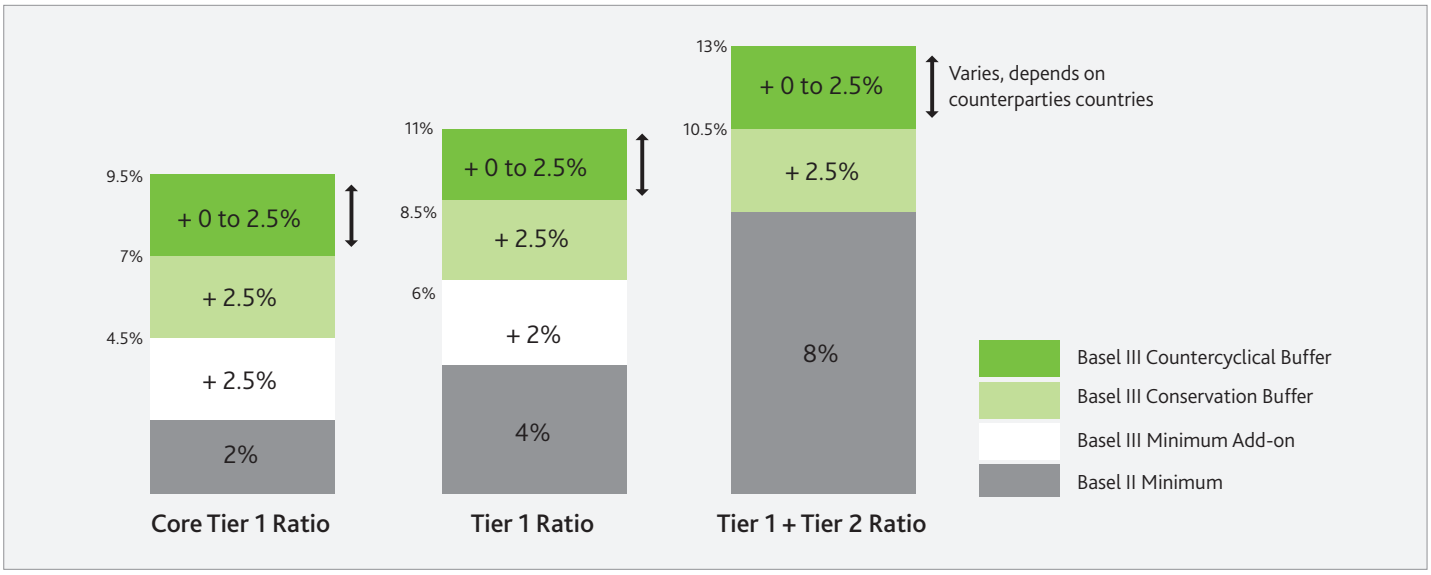
3. What is the impact on capital requirements?

Capital requirements are progressively and significantly increased and the cost of capital should be closely monitored. The diagram below demonstrates that increasing capital ratios (Core Tier 1, Tier 1, Conservation buffer, Countercyclical buffer), stricter rules on eligible capital and higher capital requirements (RWA increase for some asset classes) are driving this change.

$$\text{Capital Ratios} \uparrow = \frac{\text{Eligible Capital} \downarrow}{\text{Risk Weighed Assets} \uparrow}$$

The diagram below outlines how the Basel III minimum add-on, conservation buffer and counter-cyclical buffer will affect the core, tier 1 and tier 1+ 2 ratios.

Basel II vs. Basel III Capital Ratios



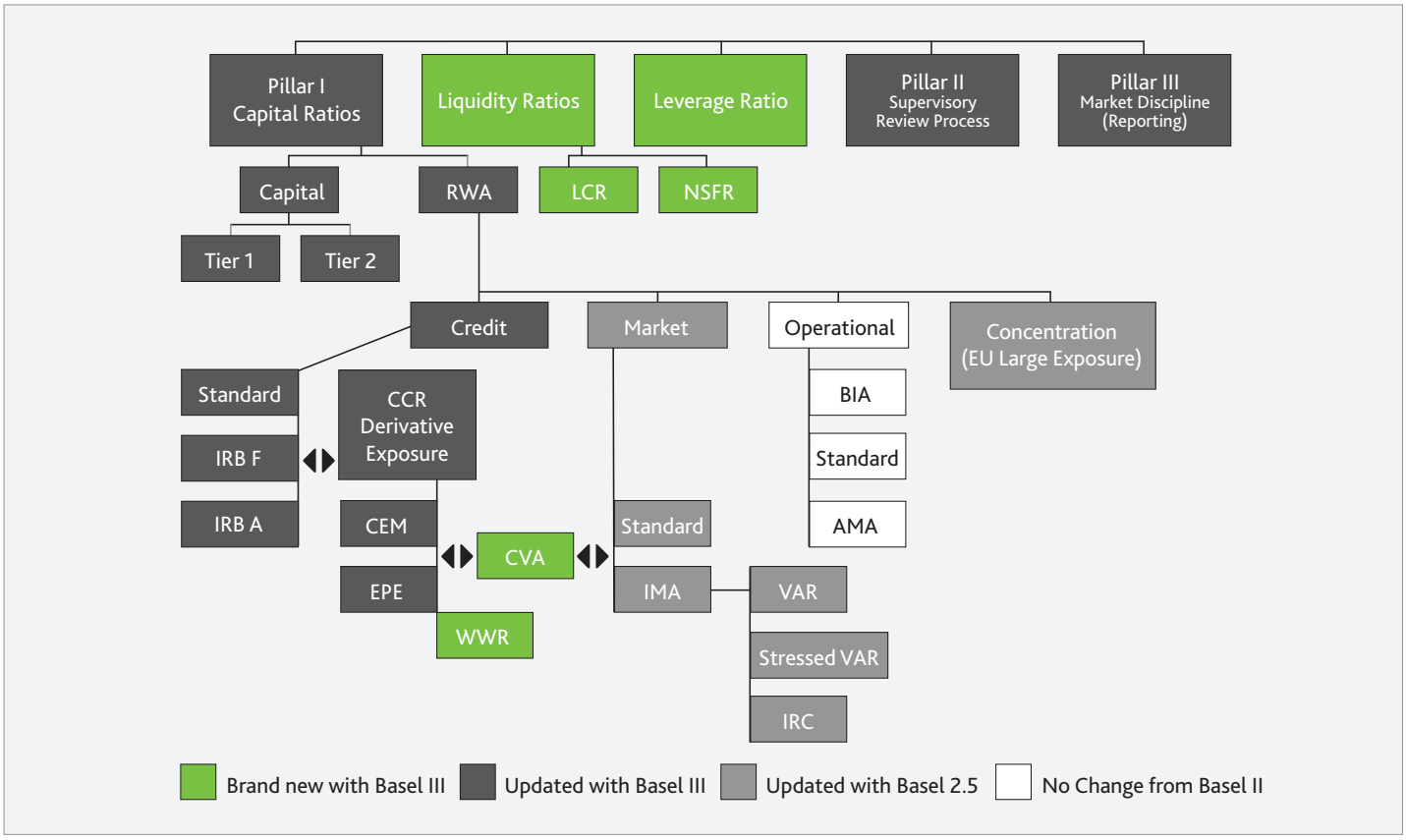
4. What are the major changes to credit risk and counterparty credit risk?

Basel III introduces capital requirements to cover Credit Value Adjustment risk and higher capital requirements for securitization products. Derivatives and Repos cleared through Central Clearing Parties (CCPs) are no longer risk-free and have a 2% risk weight and clearing members shares in CCPs default funds shall be capitalized. Additionally, Basel III introduces a higher correlation factor (applicable to internal ratings based approaches) to risk weight large and unregulated financial institutions and changes concerning collateral eligibilities and haircuts rules.

5. What does the new framework look like?

The diagram below outlines the major differences between Basel II and Basel III. It is important to note that Basel III is a fundamental overhaul of Basel II, with many elements of the regulation being updated.

Basel III - Framework



6. What are the main challenges of the new Basel III liquidity risk requirements?

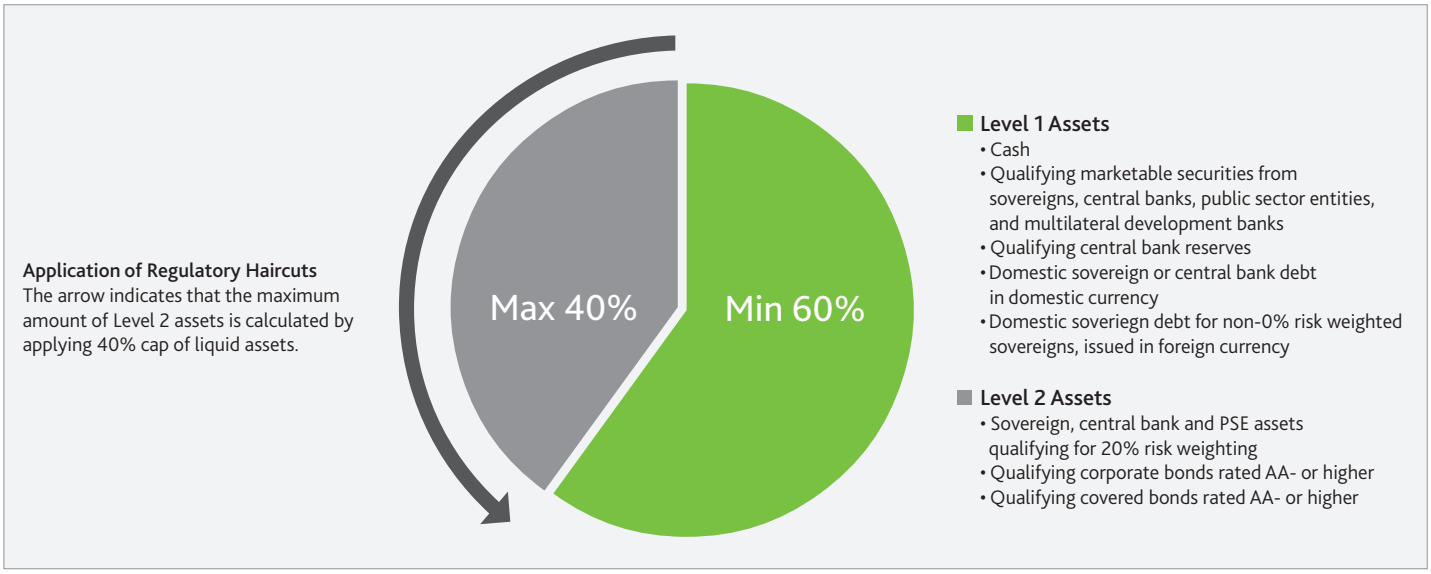
Regulatory liquidity risk reports will have to be produced at least monthly with the ability, when required by regulators, to be delivered weekly or even daily. This is challenging banks to put in place robust automated reporting solutions to meet this need.

The first challenge banks will face is to consolidate clean exposures, liabilities, counterparties and market data in a centralized risk data platform. All portfolios' contractual and behavioural cash flows should be made available and banks should have the ability to stress those and produce liquidity gap analysis according to various scenarios. LCR buffer eligibility and haircut rules rely on external ratings, Basel classification of counterparties and standardized credit risk weights. The LCR numerator run-off rates as well as NSFR, Available Stable Funding and Required Stable Funding factors also depend on such information, usually only available in risk specific systems.

The next challenge banks face is interfacing or merging their current risk and finance systems to meet the new Basel III Liquidity Risk ratio requirements. The funding concentration monitoring requirement will require banks to put in place a clean hierarchical referential of counterparties for consolidating their liabilities. Different LCR ratios will have to be produced per consolidation level and currencies. As it is already the case for credit risk rules, international banks will have to cope with various national discretions and local flavors for such new liquidity ratio rules and will have to generate various kinds of liquidity risk regulatory reporting templates in different electronic formats per jurisdiction.

7. What is the LCR Buffer composed of?

The LCR is composed of level 1 and 2 assets as outlined below:



8. Which banks will be affected?

The new Basel III regulations will affect all banks, however the severity of the impact will differ according the the type, scale and location of banks.

Most banks will be impacted by the increase in quantity and quality of capital, liquidity and leverage ratios, as well as the enhanced requirements for pillar 2 and capital preservation. Most sophisticated investment banks will be affected by the amended treatment of counterparty credit risk, the more robust market risk framework and to some extent, the amended treatment of securitizations.

Global Systemically Important Banks (G-SIBs) are subject to higher core tier 1 capital requirements.

9. What are the key dates?

The Basel Committee has outlined phase-in arrangements outlined below. Specific implementation timelines for individual countries, both members and non-members of the Basel Committee on Banking Supervision, may vary.

Phase-in Arrangements (shading indicates transition periods) (all dates are as of 1 January)

	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Parallel run 1 Jan 2013- 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar1	
Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
Minimum Common Equity plus Capital Conservation Buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)		20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus Conservation Buffer	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as Non-core Tier 1 Capital or Tier 2 Capital	Phased out over 10 year horizon beginning 2013						

Liquidity Coverage Ratio (Minimum Requirements)	Observation period begins				60%	70%	80%	90%	100%
Net Stable Funding Ratio		Observation period begins						Introduce minimum standard	

Source: Bank for International Settlements, Basel Committee on Banking Supervision.

10. How is the US Implementing Basel III?

The US is implementing Basel III, under the auspices of the Dodd-Frank Act, from 1 January, 2015 for banks utilizing the standard approach. Larger institutions (typically banks with over $250bn of assets), covered by the advanced approach, must comply by January 1, 2014. It covers almost all banking institutions and closely mirrors the BIS framework, with modifications that meet the requirements of the US regulators. The use of liquidity ratios in the US is still under review. A complexity for US banks is that banks must also manage their stress testing alongside their Basel III compliance, under the Comprehensive Capital Analysis and Review (CCAR) and the Dodd-Frank Act stress test (DFAST) frameworks. This presents a challenge as a bank's Basel III results need to be consistent with the stress testing results.

11. My organization is not Basel II compliant, what will I need to do to prepare for Basel III?

Many institutions in several countries, including the US, are not Basel II compliant, but their regulatory authorities have indicated that they will move to the Basel III framework in the future. This creates a challenge for the best organized banks as Basel II is the building block for Basel III. If a bank implements a Basel II solution before it goes to Basel III, then it should ensure that its Basel II solution is flexible enough to move smoothly from a Basel II framework to a Basel III framework.

The centralized risk and finance data platform that it implements should be able to easily accomodate a granular level of data, and should support both assets and liabilities for the calculation of the regulatory capital ratios, the liquidity ratios and, if appropriate, the stress tests results. The solution should provide a clear product roadmap that will allow a bank to migrate from its Basel I or Basel II system to its Basel III system, and this migration should include regulatory capital calculation engines and regulatory reports. And because capital requirements are increasing, the solution should be able to optimize regulatory capital calculations so that a bank is not required to hold excess capital.

From our vast experience implementing Basel I, II and III systems across the world, data is one of the most challenging and time consuming steps and should be considered early. Having granular level data has been identified as one of the biggest business benefits from implementing Basel III.

12. Should I use the advanced approach or the standard approach to calculating regulatory capital?

Implementing an advanced approach can be a costly endeavor and the cost/benefits should be examined. Using the advanced approach can result in lower capital requirements, which is beneficial from a return on capital perspective, but lower capital requirements are not guaranteed. We do anticipate that more institutions will leverage the advanced approach as a result of the higher capital requirements, which will likely make it more attractive from a capital reduction perspective.

13. What technology aspects should I consider as result of Basel III?

With increased capital requirements, allocating capital efficiently and maximizing returns becomes more important than ever. You should evaluate many of your risk and banking systems to determine if newer systems and processes can help you reduce operating costs, increase risk adjusted returns and allow you to allocate capital more effectively. We are seeing more and more with our clients that open and flexible system architectures are growing in importance. The regulations will continue to evolve beyond Basel III and you want to ensure your systems are adaptable to meet these needs.

14. How does Basel III affect my regulatory reporting requirements?

We believe that national regulators may increase the quality and quantity of data included in their national regulatory reports especially around liquidity and leverage ratios. One trend from those countries that have already implemented the regulations is that many regulators are looking to enhance their reporting requirements to capture new developments (for example the forward looking nature of stress tests). It is clear that regulatory reporting is going to become more complex as regulators strive to avoid a repetition of the 2007/8 banking crisis.

15. How can Moody's Analytics help my organization meet the new Basel III regulations?

Moody's Analytics can provide a host of solutions to help banks comply and report on Basel III, manage their stress testing, as well as optimize their liquidity and economic capital to balance the needs of the business and the needs of the regulator. The solutions all leverage the RiskFoundation™ centralized data platform, which consolidates a bank's risk and finance data to provide a single source for all calculations. The RiskAuthority™ solution utilizes the RiskFoundation platform to calculate a bank's regulatory capital, liquidity and leverage ratios for Basel III, as well as results for Basel I and II. RiskAuthority seamlessly integrates into the Regulatory Reporting Module, which utilizes reporting templates to deliver reports to over 50 supervisors. RiskFoundation also supports the Scenario Analyzer™ solution to manage stress testing, the RiskConfidence™ solution for ALM and liquidity management, and the RiskFrontier™ solution for economic capital management.

Together these solutions provide an integrated and comprehensive enterprise risk management solution for Basel III, that allows banks to manage and streamline their Basel III compliance.

For more information on our range of solutions please visit www.moodysanalytics.com or e-mail basel3@moodys.com.

About Moody's Analytics

Moody's Analytics, a unit of Moody's Corporation, helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. The company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research and financial risk management. By offering leading-edge software and advisory services, as well as the proprietary credit research produced by Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges.

CONTACT US
Visit us at **moodysanalytics.com** or contact us at a location below:

AMERICAS
+1.212.553.1653
clientservices@moodys.com

EMEA
+44.20.7772.5454
clientservices.emea@moodys.com

ASIA (EXCLUDING JAPAN)
+85.2.3551.3077
clientservices.asia@moodys.com

JAPAN
+81.3.5408.4100
clientservices.japan@moodys.com

MOODY'S
ANALYTICS

SP25076/1159/IND-401-A4