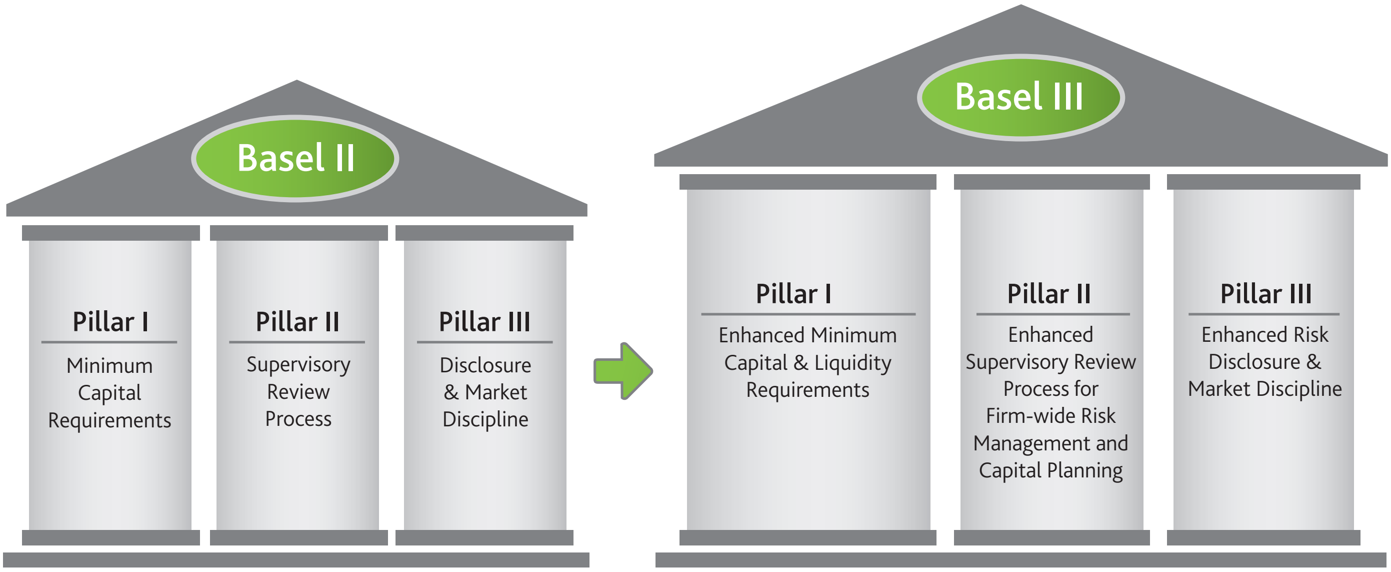
MOODY'S ANALYTICS

Basel III New Capital and Liquidity Standards - FAQs

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

Basel III proposes many new capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and new capital buffers will require banks to hold more capital and higher quality of capital than under current Basel II rules. The new leverage ratio introduces a non-risk based measure to supplement the risk-based minimum capital requirements. The new liquidity ratios ensure that adequate funding is maintained in case of crisis.



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 will be 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
New 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) » 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

Regulatory Element	Proposed Requirement
Higher Minimum Tier 1 Common Equity Requirement	» Tier 1 Common Equity Requirement: increase from 2% to 4.5% » The ratio will be 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. Introduced 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

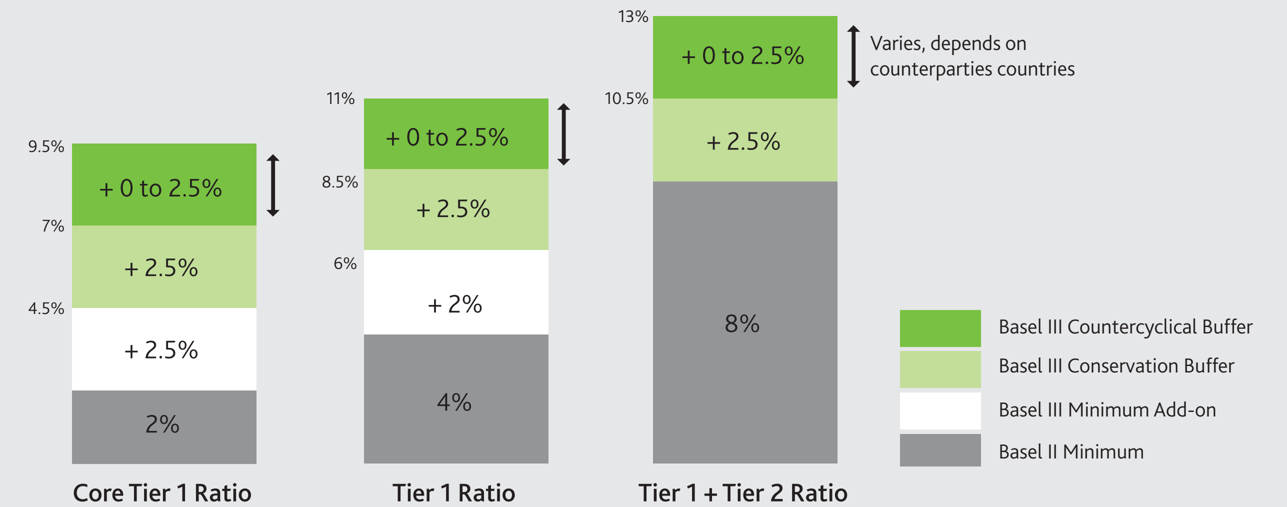
Source: Bank for International Settlements, Basel Committee on Banking Supervision.

3. What is the impact on capital requirements?

Capital requirements will progressively and significantly increase 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 causing this increase.

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

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.



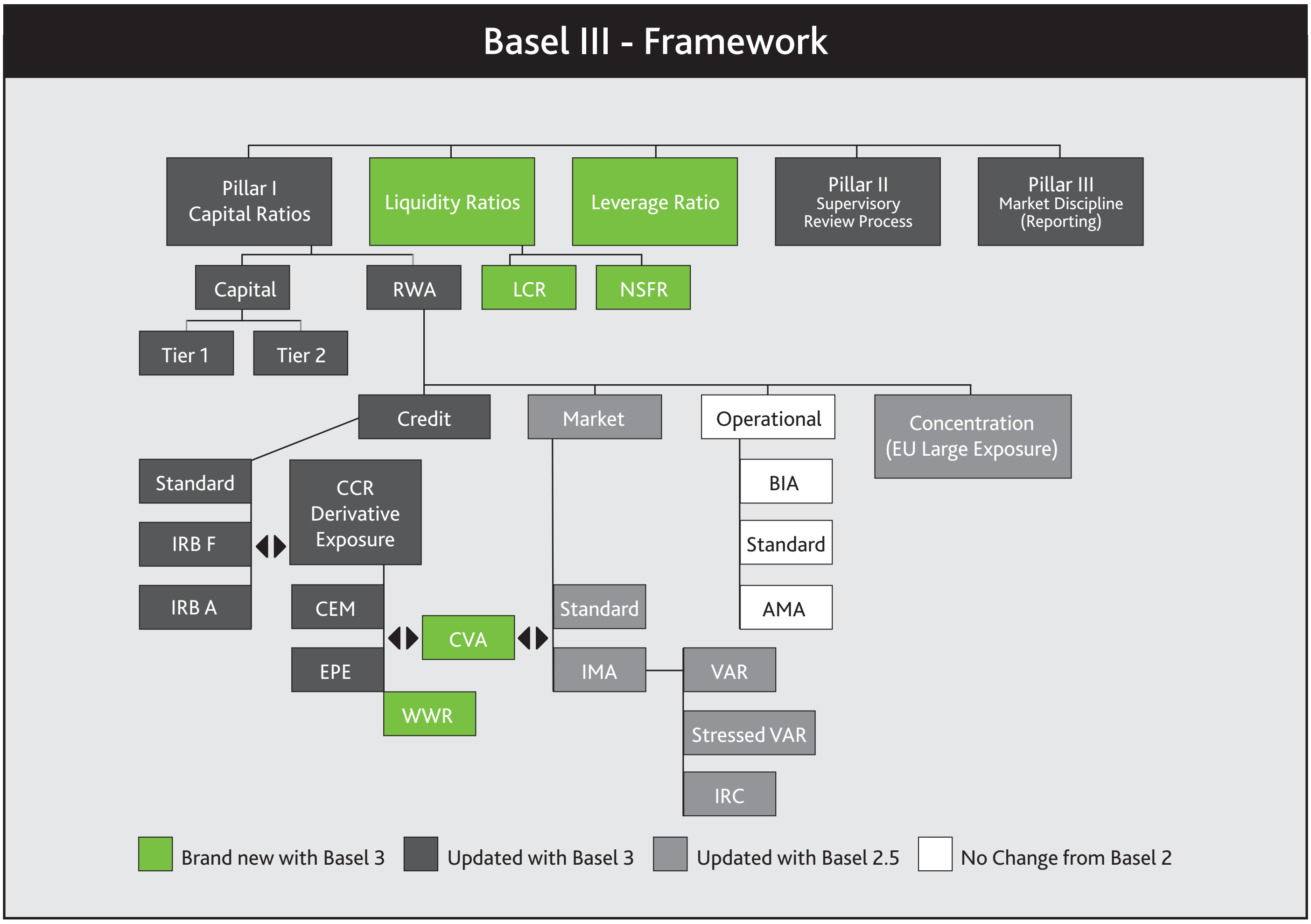
Basel II vs. Basel III Capital Ratios

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 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 upheaval of Basel II, with many elements of the regulation being updated. Brand new elements in the regulations include liquidity ratios and a leverage ratio as already outlined above.



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 datamart. 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. Liquidity Coverage Ratio (LCR) buffer eligibility and haircut rules rely on external ratings, Basel classification of counterparties and standardized credit risk weights. The LCR numerators run-off rates as well as Net Stable Funding Ratio (NSFR) Available Stable Funding and Required Stable Funding factors also depend on such information, usually only available in risk specific systems.

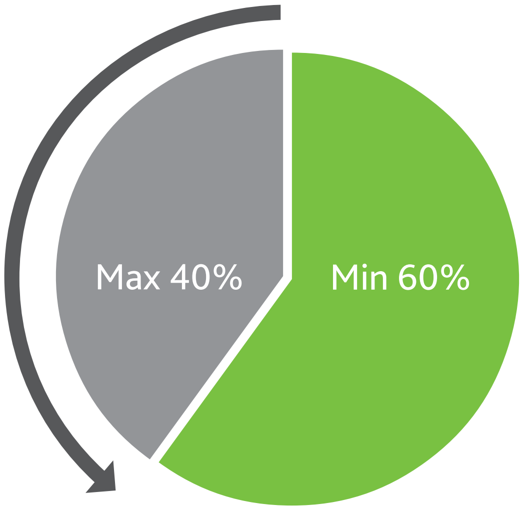
The next challenge banks face is interfacing or merging their current risk and finance systems to meet the new Basel III Liquidity Risk ratio requirements. The funding concentration monitoring requirement will require banks to put in place a clean hierarchical referential of counterparties for consolidating 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:

Application of Regulatory Haircuts
The arrow indicates that the maximum amount of Level 2 assets is calculated by applying 40% cap of liquid assets.



Level 1 Assets
- Cash
- Qualifying marketable securities from sovereigns, central banks, public sector entities, and multilateral development banks
- Qualifying central bank reserves
- Domestic sovereign or central bank debt in domestic currency
- Domestic soveriegn debt for non-0% risk weighted sovereigns, issued in foreign currency

Level 2 Assets
- Sovereign, central bank and PSE assets qualifying for 20% risk weighting
- Qualifying corporate bonds rated AA- or higher
- Qualifying covered bonds rated AA- or higher

8. Which banks will be affected?

The new Basel III regulations will affect all banks, however the severity of the impact may differ across types and size of banks.

Most banks will be impacted by the increase in quantity and quality of capital, liquidity and leverage ratios, amended 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 Systemic Important Banks (G-SIBs) will be subject to higher core tier 1 capital requirements. There are currently 29 G-SIBs.

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.

Annex 2: Phase-in Arrangements (shading indicates transition periods) (all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Supervisory monitoring		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	Observation period begins				Introduce minimum standard				
Net Stable Funding Ratio		Observation period begins						Introduce minimum standard	

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

10. Will the US adopt Basel III?

Yes. The US has stated on numerous occasions that it will move to Basel III. New capital, leverage and liquidity regulations, in line with Basel Committee rules, are part of the Dodd Frank Act Collins Amendment. It appears that all US banks will be required to meet Basel III, but large bank holding companies with over $50 million US dollar of assets should be subject to stricter rules than smaller institutions. US specific rules are to be clarified in 2012 and Basel III should take effect in early 2013.

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 a Basel III framework in the future. This creates an interesting situation because Basel II is the building block for Basel III.

If you will implement a Basel II solution before you go to Basel III then you should ensure that the Basel II solution is flexible enough to smoothly move from a Basel II framework to a Basel III framework. The financial datamart that you implement should be able to easily accomodate a granular level of data and should support both assets and liabilities for calculation of your regulatory capital as well as your liquidity ratios. A vended solution should also have a clear product roadmap that will allow you to migrate from your Basel II system to your 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 you are not required to hold excess capital.

If you can bypass Basel II and implement Basel III then you should start planning to update or replace your existing Basel I systems as quickly as possible. From our vast experience implementing Basel II 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 Basel II.

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 maximising 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. Existing capital adequacy reports will also be updated. Such additional information will also have to be reported to the market via enhancing the current bank Pillar 3 disclosures.

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

Through a combination of our breadth of experience and intuitive and flexible software, Moody's Analytics can help your organization meet the Basel III regulations. Over 110 banks globally, including some of the world's most recognized, are using our award-winning regulatory capital solution to manage their Basel II regulatory capital calculation and reporting needs. Our next generation solution for Basel III - RiskAuthority - is built on the same technology and offers comprehensive Basel III capital, liquidity and leverage ratio calculation and reporting.

We also provide an integrated economic capital solution for Pillar II ICAAP requirements, as well as an internal rating framework with proprietary and customizable models and scorecards. Additionally, we also provide solutions that allow you to allocate and price risk more effectively and to integrate risk management into the business at the point of origination, increasing operational efficiency and optimizing risk and return, which will be critical in a world with higher capital requirements. Our products are complemented with comprehensive analysis and stress testing tools and expert advisory, implementation and customization services to assist you in all phases of your project.

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

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