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European Banks: Basel III New Capital Requirements

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European Banks: Basel III New Capital Requirements

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Calibration: New Rules vs. Old Rules

	Basel II	Basel III	
	Minimum	Minimum	Minimum + Conservation Buffer
Core Tier 1 ratio	2.0%	4.5%	7.0%
Tier 1 ratio	4.0%	6.0%	8.5%
Total Capital	8.0%	8.0%	10.5%

Source: BIS, Credit Suisse

- An additional countercyclical buffer of 0 to 2.5% to be met with Common equity or other fully loss absorbing capital
- The amount of hybrid securities and Tier 2 securities in banks' capital structure is going to be more limited going forward, in our view. With regard to meeting the minimum levels, the implied limit is c.18% or [(8.5%-7.0%)/8.5%]. In most countries the current limit stands at between 35% and 50%.
- However, there is no explicit limit on Tier 1 hybrids above the minimum requirements and some banks could potentially still issue a higher amount of hybrids than the implied c.18% at the minimum level (8.5%) to meet Pillar II requirements for instance

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Transition Periods

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
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%	2.50%
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%	9.125%	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: BIS, Credit Suisse

Grandfathering

- Existing securities that do not meet the new requirements of the current capital layers (i.e. Common Equity/Tier 1 Hybrid/ Tier 2 capital) will be grandfathered for a certain period. This will be the case for the bulk of existing Tier 1 hybrids, Lower Tier 2 and Upper Tier 2 securities due to the more onerous loss absorption requirements in Basel III compliant securities (based on current proposals)
- The grandfathering arrangements only apply to securities issued before Basel's current press release (12th of September 2010)
- Tier 1 hybrids and Tier 2 capital instruments
  - Capital securities that no longer qualify as non-common equity Tier 1 or Tier 2 capital will be phased out over a 10-year period starting 1 January 2013
  - For these capital instruments 90% will be recognized in bank's capital structure from 1 January 2013 with the cap reducing by 10 percentage points in each subsequent year to January 2022
  - In addition, instruments with an incentive to redeem (e.g. innovative or step-up Tier 1 securities or callable Lower Tier 2 securities) will be phased out at their "effective maturity date" which is the first call date. We interpret this to mean that the 10% per annum amortisation starts at 1 Jan 2013 and at the first call date, the remaining balance of regulatory capital treatment is reduced to zero
  - Existing public sector capital injections will be grandfathered until 1 January 2018

Grandfathering (cont'd)

- Equity Tier 1
  - Capital instruments that do not meet the criteria for inclusion in common equity Tier 1 will be excluded from common equity Tier 1 as of 1 January 2013
  - However, instruments meeting the following three conditions will be phased over 10 years staring 1 January 2013: **1)** They are issued by a non-joint stock company; **2)** they are treated as equity under the prevailing accounting standards; and **3)** they receive unlimited recognition as part of Tier 1 capital under current national banking law

Implications for Tier 1 Hybrids

- For Tier 1 bondholders, the implications are very positive in our view, as the new rules increase the incentive to redeem the existing securities at expiry of grandfathering which is sooner than what is assumed in pricing of this segment. Additionally, the amount of Tier 1 hybrids outstanding is likely to shrink given the larger portion of the Total Capital requirement to be met with Common Equity than before
- Relative to expectations, we believe the grandfathering period was generally shorter than expected, particularly for Step-Up (or Innovative Tier 1 securities) which will cease to attract Tier 1 hybrid regulatory capital treatment post the call date, thus increasing the probability of a redemption of the security at the first call date very significantly
- Pricing of Yield-to-ER (Yield to Expected Redemption) is likely to migrate towards the Yield-to-Call for Step-Up Securities in our view. For Non-Step Tier 1 hybrids, we expect at the very least that pricing of Yield to ER to migrate from Yield-to-Maturity towards to Yield-to-2020-2022 redemption range (where the regulatory capital treatment is very low (<20%).
- The above dynamics are supportive for our Overweight recommendation on Tier 1 hybrids, as well as our preference for low cash price securities, in our view
- For high cash price Tier 1 securities the grandfathering arrangements could potentially be negative for the price of these securities because of potential regulatory calls at par, a risk we raised in our 2010 Outlook publication on 5 January 2010. The exact date that the regulatory call becomes applicable depends on the exact language describing the regulatory call feature. Where the regulatory call is triggered when regulatory capital treatment is lost in whole or in part, the regulatory capital call will be applicable on 1 Jan 2013. Obviously, where the regulatory call is triggered at loss of regulatory capital treatment in whole and not in part, the applicable date from when the regulatory call can be triggered will be 1 Jan 2022. (For Step-Up securities, it will be the earliest of call or 1 Jan 2022 of course)

Implications for Tier 2 securities

- For callable Lower Tier 2, the implication is also positive as extension risk beyond the first call date has been considerably reduced to loss of regulatory treatment at the first call date. Standard regulatory treatment (in most countries) post the first call date of 20% per year is thus no longer relevant on existing securities. The positive in this regard on Lower Tier 2 is less profound than on Tier 1 hybrids as the Lower Tier 2 securities were trading with a lower risk of extension beyond the first call date as well as due to the the lower differential in spread duration between YtC and YtM than in the Tier 1 hybrids
- For Bullet Lower Tier 2 capital instruments, the impact is less significant although long duration securities could potentially benefit from tender offers before the expected redemption date although this is sensitive to developments on cost of senior debt going forward
- For Upper Tier 2 securities, the pricing convention of Yield-to-ER (Yield to Expected Redemption) should also migrate towards Yield-to-Call given full loss of regulatory capital treatment from the first call date
- A further positive is that the amount of Tier 2 capital outstanding is likely to shrink given the larger portion of the Total capital requirement to be met with Common Equity than before
- Regulatory call risk is relevant for Lower Tier 2 securities as well in cases of high cash price securities with regulatory call language at par

Implications for Contingent Capital securities

- For the contingent capital securities (ECNs) issued by Lloyds Banking Group (LBG), the 4.5% Core Tier 1 level banks need to comply with is supportive for valuation in our view
- The trigger event on the ECNs is a Core Tier 1 ratio of 5.0% as defined by the FSA as of 1 May 2009, meaning that the likelihood of LBG breaching this trigger is more remote, especially as banks might see the effective minimum Core Tier 1 ratio as 7.0% (4.5% minimum Core Tier 1 + 2.5% conservation buffer) going forward
- However, the loss of Tier 2 treatment in part as from 1 Jan 2013 effectively allows Lloyds to call the ECNs at par from that date, in our opinion. We highlighted this risk in our 2010 outlook note on 5 January 2010 and was the reason for our strong preference of the low cash price, long duration ECNs
- As an asset class, we suspect that Contingent Capital securities will potentially be allowed to meet the additional countercyclical buffer of 0% to 2.5%, as Basel stated that this requirement can be met with ‘other fully loss absorbing capital’ in addition to Common Equity. Future Tier 1 hybrids and Tier 2 capital is of course a form of contingent capital in itself given the requirement for permanent loss absorbency language in both future Tier 1 hybrids and Tier 2 instruments (based on current proposals)

Implications for Senior Debt

- In general, the Basel III capital requirements are less onerous than expected due to a combination of lower level(s) of calibrated requirement(s) as well as the longer than expected phase-in periods
- For senior unsecured bank debt, where bondholders benefit from higher levels of junior ranking capital, this is marginally positive from a fundamental perspective
- The new rules are on balance very supportive of our preference for Non Dilutive Capital Securities (Overweight) over Senior unsecured bank debt (Market Weight), in our view.
- A key implication for senior debt going forward will be the developments regarding Resolution Regimes and to what extent the legislative framework could be amended to allow senior bondholders to potentially absorb losses outside a liquidation as part of a restructuring of a distressed bank
- The Basel Committee and the FSB [Financial Stability Board] are developing an integrated approach to “systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. In addition, work is continuing to strengthen resolution regimes”

Capital Ratios as at H1 10

H1 09

	CT1	T1	TC	RWA	CCY
Barclays	10.0	13.2	16.5	395,000	GBP
Bradford & Bingley	11.3	12.1	14.8	19,300	GBP
HBOS	8.3	9.4	12.1	298,555	GBP
HSBC	9.9	11.5	14.4	1,075,264	USD
Lloyds Banking Group	9.0	10.3	13.4	463,196	GBP
Lloyds TSB Bank	8.5	10.3	12.6	463,196	GBP
Nationwide Building Society*	12.2	15.3	19.4	50,073	GBP
Royal Bank of Scotland	10.5	12.8	13.9	474,000	GBP
Standard Chartered	9.0	11.2	15.5	234,184	USD
Allied Irish Banks	6.9	6.0	9.0	112,700	EUR
Anglo Irish Bank	10.6	11.6	16.4	62,620	EUR
Bank of Ireland	10.2	9.9	12.5	93,000	EUR
Irish Life & Permanent	10.7	10.7	not discl.	16,603	EUR
Bawag	6.8	9.0	11.7	24,769	EUR
BayernLB**	9.5	10.4	15.7	130,300	EUR
Commerzbank******	9.4	10.8	14.4	290,200	EUR
Deutsche Bank	7.5	11.3	11.9	303,460	EUR
Deutsche Postbank	5.0	7.3	9.9	70,763	EUR
Erste Bank	8.6	9.6	12.9	104,900	EUR
Eurohypo	7.8	9.1	13.1	70,100	EUR
Hypo Real Estate******	6.9	8.4	10.1	84,500	EUR
HSH Nordbank******	7.7	9.8	14.1	65,248	EUR
HVB Group	14.6	15.3	17.7	134,000	EUR
Hypo Alpe-Adria-Group******	1.7	7.3	10.6	29,900	EUR
Raiffeisen****	8.5	9.3	12.8	77,646	EUR
WestLB******	7.6	10.1	14.6	53,400	EUR
Banque Federative du Credit Mutuel*	8.9	10.3	10.0	168,242	EUR
BNP Paribas	8.4	10.6	14.5	633,000	EUR
Credit Agricole	9.1	9.7	10.1	344,000	EUR
BPCE	7.4	9.6	not discl.	428,000	EUR
Natixis	8.1	9.2	10.7	139,100	EUR
Societe Generale	8.5	10.7	not discl.	330,300	EUR
Banca Popolare di Milano*	7.7	8.4	12.3	34,238	EUR

	CT1	T1	TC	RWA	CCY
Banco Popolare* ***	7.3	8.8	11.5	92,623	EUR
Intesa Sanpaolo	7.7	8.9	12.2	355,655	EUR
Mediobanca*******	>11%			52,389	EUR
Monte dei Paschi di Siena* ******	5.3	7.8	12.2	120,899	EUR
UBI Banca	7.3	7.9	11.9	85,677	EUR
UniCredit	8.4	9.4	12.7	459,047	EUR
Bancaja	7.0	7.9	12.1	70,676	EUR
BBVA	8.1	9.2	12.7	309,617	EUR
Banco de Sabadell	6.6	7.8	10.1	60,354	EUR
Banco Pastor	8.3	10.4	11.6	18,858	EUR
Banco Popular Espanol	8.6	9.1	9.5	95,159	EUR
Bankinter	6.5	7.3	9.7	32,281	EUR
Caja Madrid	6.6	8.7	10.8	123,781	EUR
La Caixa	8.6	9.8	11.6	161,275	EUR
Banco Santander	8.6	10.1	13.5	601,518	EUR
Banco Comercial Portugues	6.6	8.9	9.7	59,527	EUR
Banco Espirito Santo	8.3	8.9	12.2	59,453	EUR
Caixa Geral de Depositos	8.2	8.4	12.8	not available	EUR
ESFG*	6.9	8.0	9.6	67,898	EUR
Dexia	11.3	12.2	not discl.	143,170	EUR
ING Bank	8.6	11.2	14.2	343,891	EUR
KBC	9.7	11.4	14.9	139,089	EUR
Rabobank	13.5	14.9	15.3	223,304	EUR
SNS Bank*****	8.6	11.1	14.5	30,700	EUR
Van Lanschot Bankiers	8.0	10.1	11.9	13,521	EUR
Danske Bank	9.1	13.7	17.2	879,029	DKr
DnB NOR	8.5	9.3	12.1	1,052,566	NOK
Nordea	10.0	11.1	13.2	206,000	EUR
Skandinaviska Enskilda Banken	12.1	14.3	14.5	714,000	SEK
Svenska Handelsbanken	14.1	14.8	19.9	586,893	SEK
Swedbank	12.7	14.0	17.9	579,391	SEK
Credit Suisse Group	11.4	16.3	21.8	232,964	CHF
UBS	13.0	16.4	20.4	204,848	CHF
Alpha Bank	8.7	11.4	13.0	14,596	EUR
EFG Eurobank Ergasias*	8.0	10.6	11.8	47,827	EUR
National Bank of Greece***	9.6	10.7	not discl.	71,032	EUR

*As at FY09, for BPIM, MILANO, UBIIM, EFG only RWA at FY09, **CT1 and TC as at FY09, ***Proforma, ****RWA (Credit Risk), *****RWA under Basel I, ******CT1 calculated using FY09 hybrids, *******RWA as at 1H09/10, CT1 at 9M09/10

Source: Company Reports, Credit Suisse

European Credit Research: Financial Institutions

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