NEDBANK
BALANCE SHEET MANAGEMENT

Strengthening the resilience of the banking sector

Basel 3 Teach-in

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MAKE THINGS HAPPEN

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Strengthening the resilience of the banking sector ("Basel 3")

Contents

- July 2009 requirements
- December 2009 proposals
  - Raising quality, consistency & transparency of capital base
  - Enhancing risk coverage
  - Leverage ratio
  - Reducing procyclicality & promoting countercyclical buffers
  - Addressing systemic risk & interconnectedness
  - Global liquidity framework
- Timelines

Summary of the new Basel requirements….first response package

July 2009 requirements

- Enhancements to **Pillar 1**
  - Securitisation (implementation was end 2009)
  - Market trading risk (implementation by end 2010)
- Enhancements to **Pillar 2** (ICAAP) (implementation 1 July 2009)
  - Bank-wide governance & risk management
  - Principles for sound liquidity risk management
  - Principles for risk concentrations
  - Sound remuneration practices (risk-based)
  - Valuation & liquidity risks of financial instrument fair value practices
  - Principles for sound stress testing practices
  - Off-balance sheet exposures & securitisation activities
  - Reputational risk & implicit support
- Enhancements to **Pillar 3** (public disclosure)
  - Securitisation exposures (implementation was end 2009)

Raising the quality, consistency & transparency of the capital base

December 2009 proposals

- Clear differentiation between capital available to support the bank as a **going concern** (Tier 1) & only in case of default, **gone concern** (Tier 2)
- New definition of Tier 1 capital components & introduction of concept of "Common Equity" as predominant form of Tier 1 capital (i.e. "**Core Tier 1**")
- Current innovative Hybrid Tier 1 capital (i.e. with step-up clauses) excluded from Tier 1
- Harmonisation of regulatory capital adjustments internationally & Core Tier 1 application
- Simplification of Tier 2 formats (i.e. one type of Tier 2 instrument vs. Upper & Lower Tier 2 differentiation & removal of current limitation that Tier 2 cannot exceed Tier 1)
- Abolishment of Tier 3 capital (i.e. ensure capital used to meet market risk requirements shares same quality of capital used to cover credit & operational risks)
- Introduction of three revised regulatory ratios (Common Equity [Core Tier 1], Tier 1 & Total capital ratios) & respective minima (still to be established)
- Contingent capital & convertible capital instruments (WIP, July 2010)
- Clear public disclosure of components of capital & reconciliation with AFS

Definition of Capital

Regulatory Adjustments Applied to Regulatory Capital (1/3)

Regulatory adjustments & deductions will be applied to common equity (core Tier 1). The impact of these deductions will be evaluated in the quantitative impact study in H1 2010.

Capital Deductions	Inclusion in Capital		
	Common	Tier 1	Total
Preferred Stock Surplus • Surplus will only be permitted to be included in common equity if the corresponding shares are permitted in common equity	✘	✓	✓
Minority Interest • Will not be eligible for inclusion in the common equity component of Tier 1, even if the instrument is common equity of a regulated subsidiary	✘	✓	✓
Unrealised Gains / Losses on Debt, Loans, Equity • No adjustment should be applied to remove from the Common Equity component of Tier 1unrealised gains or losses recognised on the balance sheet	✘	✘	✘
Goodwill & Other Intangibles • Potentially all goodwill & intangibles may be deducted, net of any deferred tax liability	✘	✘	✘

Raising the quality, consistency & transparency of the capital base

December 2009 proposals

Definition of Capital

Regulatory Adjustments Applied to Regulatory Capital (2/3)

Capital Deductions	Inclusion in Capital		
	Common	Tier 1	Total
Deferred Tax Assets • DTAs which rely on future profitability of the bank to be realized should be deducted from common equity (net of DTLs)	✘	✘	✘
Investments in own shares • Bank investments in its own common shares should be deducted from common equity, including equity that the bank may be contractually obligated to purchase – This includes bank trading books, & holdings within index securities	✘	✘	✘
Investments in capital of certain financial entities which are not consolidated • All reciprocal cross holdings or investments in affiliated institutions are to be deducted on a corresponding basis • Holdings of common stock in financial institutions exceeding 10% of the financial institution should be deducted in full – Deductions should apply to the same component of the bank's capital as the instrument held by bank • If the aggregate amount of holdings in the common stocks of other financial institutions exceeds 10% of its its own common equity (after deductions), the amount in excess of 10% should be deducted • Deductions apply to bank trading & banking books, & to holdings within index securities	✘	✘	✘

Raising the quality, consistency & transparency of the capital base

December 2009 proposals

Definition of Capital

Regulatory Adjustments Applied to Regulatory Capital (3/3)

Capital Deductions	Inclusion in Capital		
	Common	Tier 1	Total
Shortfall of Provisions to Expected Losses • Any difference between expected losses under the IRB approach & actual bank provisions should be deducted 100% from common equity	✘	✘	✘
Cash Flow Hedge Reserve • Positive & negative cash flow hedge reserves should be removed from common equity, where the related cash flows are not recognized on balance sheet	✘	✘	✘
Cumulative Gains & Losses Due on Fair Valued Financial Liabilities • Extended from prior proposal to include gains & losses due to changes in own credit risk on all fair valued liabilities	✘	✘	✘
Defined Benefit Pension Fund Assets • No filter applied to defined benefit pension fund liabilities • Defined benefit pension fund asset should be deducted from common equity	✘	✘	✘

Additionally, certain assets which previously received capital deductions split between Tier 1 (50%) & Total Capital (50%) will receive risk weightings of 1250%. Relevant asset exposure include certain securitizations & equity exposures

Enhancing risk coverage

December 2009 proposals

- July 2009 requirements strengthened the following
  - Trading book (eg **stressed** VaR based on 12 months of significant financial stress)
  - Complex securitisation exposures
- December 2009 proposals
  - Raise capital requirements for counterparty risk exposure arising from banks' derivatives, repo & securities financing activities
  - Banks to be subject to a capital charge for mark-to-market losses associated with a deterioration in the credit worthiness of a counterparty (& not just triggered in case of default)
  - Incentive to enter into derivatives contracts through central counterparties & exchanges….. banks' collateral & mark-to-market exposures to central counterparties will generally qualify for zero percent risk weight vs increased capital requirements to be applied to bilateral OTC transactions

Enhancing risk coverage

December 2009 proposals

Topic	Proposed Changes
Wrong-way risk & mark-to-market losses	• Effective EPE (expected positive exposure) with stressed parameters to address general wrong-way risk • Implementation of an explicit Pillar 1 capital charge where specific wrong-way risk identified • Regular reports to senior management & Board committee • To better capture credit valuation adjustments (CVA) losses
Interconnectivity of large financial institutions	• A multiplier for the asset value correlation for large financial institutions is to be introduced … proposing a multiplier of 1.25 • Application of the multiplier limited to exposures to banks, broker/dealers & insurance companies with assets of $25 billion or more
Collateralised counterparties & margin period of risk	• Increase the margin period of risk for certain netting sets • Revise the shortcut method for estimating Effective EPE • Preclude downgrade triggers from being reflected in EAD (exposure at default) • Added requirements to improve the operational performance of the collateral department • Revise credit risk mitigation section to add a qualitative collateral management requirement • Establish increased st&ard supervisory haircuts for securitisation collateral • Greater definition around requirements for PD estimates for highly leveraged counterparties

Enhancing risk coverage

December 2009 proposals

Topic	Proposed Changes
Central counterparties	• Incentive for banks to use CCPs/exchanges for OTC derivatives
Enhanced counterparty credit risk (CCR) management	• In addition to enhancing the requirements for wrong-way risk, strengthening the CCR risk management requirements including – Stress testing – Backtesting
Securitisation framework	• Fundamental review of the securitisation framework, which may lead to a recalibration of the capital charges
Other issues raised for consideration	• Requirements for banks to perform their own internal assessments of securitisation exposures • Strengthening of the eligibility criteria for external credit assessment institutions (ie Rating Agencies) • Incorporation of key elements of the IOSCO Code of Conduct Fundamentals for credit rating agencies into the eligibility criteria for the use of external ratings

Leverage ratio

December 2009 proposals

- Implement a globally consistent leverage ratio as a non-risk based 'backstop' measure based on gross exposure
  - Will be harmonized internationally & adjust for material accounting differences
  - Will include off-balance sheet exposures

$$\frac{\text{Tier 1 or Tier 1 Common}}{\text{Total assets including off-balance sheet exposures}}$$

- Definition will be capital divided by total exposure as defined below
- Capital may be measured as Tier 1 Common (core) or Tier 1 Capital & Total Capital
- Total exposure will include:
  - All on balance sheet items (including cash & liquid securities)
    - Based on accounting treatment & net of provisions
  - Items deducted from capital also deducted from exposure
  - Off-balance sheet items included with a 100% credit conversion factor
    - Includes unconditionally cancellable commitments, st&by letters of credit
  - Full notional amount of written credit derivatives included
  - No reduction of exposure for collateralized or guaranteed exposures
  - No netting of exposures (e.g. derivatives or loans against deposits)

Reducing procyclicality & promoting countercyclical buffers
December 2009 proposals

Key objectives

- Dampen any excess cyclicality of the minimum capital requirement
- Promote more forward looking provisions
- Conserve capital to build buffers that can be used in stress
- Protecting the banking sector from periods of excess credit growth

Cyclicality of the minimum requirement

- In place already:
  - dLGD (downturn loss-given-default)
  - Long-term data horizon
  - Stress testing

  (implementation internationally has been the issue!)
- Proposals:
  - Data collection initiative to better assess impact of procyclicality under current Basel 2
  - dPD / TTC PD / use of Pillar 2?

Reducing procyclicality & promoting countercyclical buffers

December 2009 proposals

Forward looking provisioning

- Encouraging / supporting the IASB change in accounting st&ards for credit impairments (IAS 39) towards an “expected loss” rather than “incurred loss” approach
  - Exposure Draft released in November 2009
    - Much enhancement needed to the ED
- Removal of disincentives to sound provisioning practices
  - Any difference between IRB expected losses & actual provisions will be deducted fully from common equity (previously split between Tier 1 (50%) & Tier 2 (50%))
  - Excess provisions over IRB expected losses are currently capped as a share of RWA within Tier 2. This cap will be reviewed.

Reducing procyclicality & promoting countercyclical buffers

December 2009 proposals

Capital conservation

- Conserving capital to build buffers that can be used in periods of stress
  - Introduction of a framework linking the amount of earnings a bank is allowed to distribute to shareholders to the bank's capital ratios

Individual Bank Minimum Capital Conservation St&ards (illustrative only - detail proposal by July 2010)		
Amount by which the bank's capital exceeds minimum requirement (as a % of the conservation range)	**Minimum Capital Conservation Ratios (as a % of earnings)**	**Implied Payout Ratio (as a % of earnings)**
[<25%]	[100%]	[0%]
[25% - 50%]	[80%]	[20%]
[50% - 75%]	[60%]	[40%]
[75% - 100%]	[40%]	[60%]
[100%]	[0%]	[100%]

  - Distributions include dividends, share buy-backs & discretionary bonus payments
    - Basel paper on remuneration principles & st&ards released in January 2010

Excess credit growth

- Banks to further increase capital buffers available when selected macroeconomics indicators suggest credit volumes have grown excessively (Basel to fine-tune detailed proposal on this topic by July 2010)

Addressing systemic risk & interconnectedness

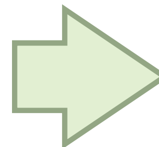
December 2009 proposals

- This is WIP, specific proposals due in H1 2010
- Is about interconnectedness of large banks & other financial institutions
- Options being considered by Basel:
  - Capital surcharge
  - Liquidity surcharge
  - Increase the Financial Institutions risk weight functions (eg 25% increase)
- In South Africa, we already have a pillar 2a 1,5% add-on

Global liquidity framework

December 2009 proposals

- Two **key liquidity ratios** designed to strengthen liquidity risk management & supervision
- Also to adhere to all the principles set out in the September 2008 document **"Sound Principles for Liquidity Risk Management"**
- In addition a **minimum set of monitoring tools**
  - **Contractual maturity mismatch**
  - **Concentration of funding** – Concentration of wholesale funding by counterparty, instrument & currency
  - **Available unencumbered assets**
  - **Market related monitoring tools** – For example market data on credit default swap spreads, equity prices, cost of wholesale funding, etc



1. Liquidity Coverage Ratio (LCR)

- The LCR identifies the amount of unencumbered, high quality liquid assets an institution is required to hold in order to offset the cumulative net cash outflows it would encounter under an acute short-term (30 day) stress scenario

$$\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} \geq 100\%$$

2. Net Stable Funding Ratio (NSFR)

- The NSFR measures the amount of longer-term, stable funding sources required by an institution given the liquidity profile of its assets & the contingent liquidity risk arising from off-balance sheet exposures (OBEs)
- The st&ard requires a minimum amount of funding that is expected to be stable over a 1 year horizon based on liquidity risk factors assigned to assets & OBEs
- The NSFR is intended to promote longer-term structural funding of a bank's balance sheet

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

Global liquidity framework

December 2009 proposals

Impact on SA Banks = potentially pervasive (if proposals implemented "as is" which is unlikely)

South African banks are well funded & liquid (due to the small & closed nature of the funding system) as evidenced throughout the global financial crisis. However….

- SA banks expected to fall short of the proposed liquidity ratios due to **structural issues**
  - SA retail customers have a low savings rate
  - No deposit insurance
  - SA banks having been disintermediated by money market funds which account for nearly a third of total funding. This has resulted in more expensive funding (due to the wholesale nature) as well as a shorter liquidity profile
  - Almost 90% of assets are "corporate" & "mortgage" loans which are typically long duration
  - Small & less liquid capital markets limits the banks' access to alternate liquid assets, & exchange controls restrict buying of foreign assets
- Minimum target for both ratios is 100% but current estimate is that SA banks are c.40% on the LCR & c.60% on the NSFR
  - In relation to the LCR, SA banks would be short around R500bn in liquid assets

Global liquidity framework
December 2009 proposals

- We think SARB will adopt framework but modify appropriately for SA…some possibilities include:
  - Change some definitions (e.g. apply look through principle to money market funding & classify as retail)
  - Lengthened implementation period to make compliance achievable for SA banks & also to allow SARB adequate time to interact with Government / National Treasury to address some of the structural issues
  - Reduce minimum target ratio; maintaining global comparability of calculations but modifying for SA's structural issues
  - Adjusting for SA not being aligned with other jurisdictions in terms of deposit insurance schemes
  - Clarity on whether cash reserves & liquid assets will be allowed to qualify as part of the stock of highly liquid assets. Currently SARB only allows 25% of liquid assets & 0% of cash reserves to qualify (the Basel paper suggests that 100% of sovereign paper & 100% of cash reserves could qualify)
  - The "closed" nature of SA's money markets, resulting from exchange controls, means that R&s are more sticky for R& banks (in the R& system) than for Euro or Dollar denominated banks (in their respective systems) which are more "open". To recognise the benefits of SA's closed system
  - SA asset managers (in the closed system) have four large banks to deposit funds. In Europe & the US a lot more banks to deposit funds with, meaning wholesale funding is less "sticky" compared to SA
  - Given that liquidity risk is a consequential risk, legislation such as National Credit Act (NCA) must reduce systemic risk & need for oversized liquidity buffers (many developed economies do not have safety net of NCA type legislation yet)

Impacts of proposals (beyond liquidity risk)

December 2009 proposals

- Other aspects receiving major focus in the global banking industry include:
  - Risk culture, which is seen as key to successful implementation
  - Risk governance
  - Risk appetite
  - Risk-based remuneration
    - New Basel paper released Jan 2010
  - Integrated enterprise-wide risk management
  - Portfolio approach to risk management

Impact on SA Banks = moderate

Aside from the liquidity proposals…..our reasons for this are as follows:

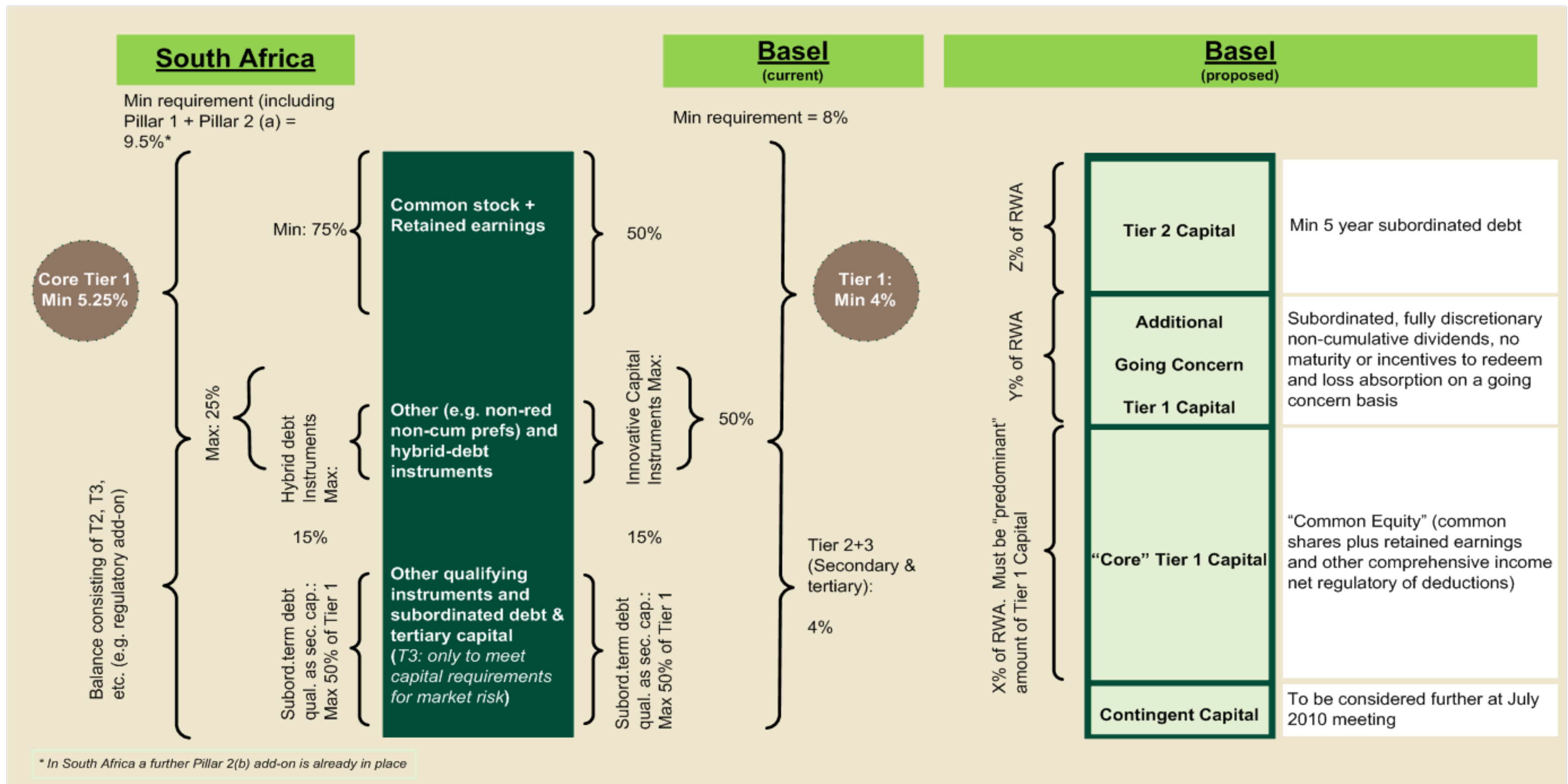
- South Africa fully embraced its Basel II implementation completed two years ago
  - USA planned implementation date is April 2011

A lot of the global issues around poor risk & balance sheet management is a matter of implementation, governance, risk cultures & lessons that needed relearning

Impacts of proposals (beyond liquidity risk)

December 2009 proposals

- On the proposed new **capital** requirements:
  - South African banking's regulatory capital rules are already much more conservative



  - Clearly the focus now is on "Core Tier 1" & levels of capital being higher than historically
  - SA banks are strongly capitalised at all levels

Impacts of proposals (beyond liquidity risk)

December 2009 proposals

- **Leverage ratio**
  - SA banks well below 20% & well below the international average
- **Risk coverage**
  - Will impact (unlikely to be material, but impact study needed) especially the stressed VaR (market risk) & CCR proposals, concentration risk & FIs risk weight increases
  - SA banks generally not involved in complex / exotic derivatives as exist overseas
- **Procyclicality & countercyclical capital framework**
  - Intended dampening of procyclicality via proper “through-the-cycle” (TTC) or “downturn” PDs (dLGDs already applied) used in IRB credit approach may have a limited impact (depends on each bank's underlying IRB models)
  - Exposure draft (ED) on credit impairments released by IASB on proposed move to an “expected loss” approach to credit provisioning rather than current “incurred loss” model. Much work still needed in ED & too early to comment on expected impact
- Banking industry **systemic risk**
  - Ongoing work on proposals but in SA an unique Pillar 2(a) 1,5% & Pillar 2(b) add-on, additional to the minimum Basel II 8% ratio requirement, already in place

OVERALL "BASEL 3" WILL REQUIRE A SIGNIFICANT EFFORT IN SOUTH AFRICA

Timelines

Basel December 2009 proposals implementation timeline

H1 2010	16 April 2010	July 2010	H2 2010	31 Dec 2010	31 Dec 2012	Post 2012
• Quantitative impact study "QIS" for capital & liquidity st&ards	• End of comment period on Basel proposals	• Next Basel meeting to discuss outst&ing items	• Review minimum capital st&ards • Calibrate levels	• Finalise Basel proposals	• Implementation of global reforms	• Gr&fathering / transition period (TBD)

IASB Credit Impairments ED Timetable

Nov 2009	30 June 2010	H2 2010	2012 / 2013
• Issued Exposure Draft (ED)	• End of comment period on ED	• Finalise requirements	• Implementation date (early adoption possible)

Questions

Thank you…………..Questions?