Implementation of the Risk-Based Capital Regulations

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STRENGTHENING COMPETENCIES IMPLEMENTING CHANGES

Outline

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- Types of Capital
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  - BSP Implementation of Basel I
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STRENGTHENING COMPETENCIES IMPLEMENTING CHANGES

Role of Capital

- Absorbs losses
- Supports risk taking and growth
- Provides depositor and creditor safety
- A key contributor to an institution's safety and soundness

Types of Capital

Accounting Capital

Assets − Liabilities = Capital

Unimpaired/Adjusted Capital

(Section 24 of R.A No. 8791 [General Banking Law] and Section X111 of the MORB)

Unimpaired Paid-in Capital	P -
Surplus and Undivided Profits	-
Regulatory Adjustments:	
Unbooked valuation reserves	(-)
Unsecured DOSRI accommodations	(-)
Unimpaired Capital	**P -**

Economic/Internal Capital

Pillar 1 Risks: Credit, Market, Operational

Pillar 2 Risks: Liquidity, Compliance, Reputation, Strategic, Interest Rate in the Banking Book, Other Risks

→ Internal Capital

Risk-based/Qualifying Capital

$$\frac{\text{Capital}}{\text{Risk-weighted Assets}}$$

Risk-weighted Assets: Credit, Market and Operational Risks

The Basel Committee on Banking Supervision

The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters.

The mandate of the Committee is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

The Basel Committee on Banking Supervision

1973: Breakdown of the Bretton Woods System

1974: Closure of the Franklin National Bank of New York

1974: Withdrawal of Bankhaus Herstatt's banking license

1975: First meeting of the Committee

The Basel Committee on Banking Supervision

Original Members: G10 Countries

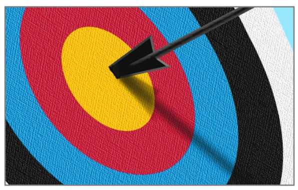
Belgium | Canada | France | Germany | Italy

Japan | The Netherlands | Sweden | The UK | Switzerland

The USA

Current members: 28 jurisdictions

The Basel Committee on Banking Supervision



Objectives:

- Enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide
- Close gaps in international supervisory coverage so that:
  1. Foreign banking establishments would be within the scope of supervision; and
  2. Supervision would be adequate and consistent across member jurisdictions.

The Basel Committee on Banking Supervision

The Committee seeks to achieve its objectives by:

- Setting minimum standards for the regulation and supervision of banks; and
- Sharing supervisory issues, approaches and techniques to promote common understanding and to improve cross-border cooperation.

Basel I: The Basel Capital Accord

A capital measurement system commonly referred to as the *Basel Capital Accord* (1988 Accord) was approved by the G10 Governors, released to banks in July 1988 and implemented by the end of 1992.

$$\text{Capital Adequacy Ratio (CAR)} = \frac{\text{Capital}}{\text{Risk-weighted Assets (RWA)}}$$

Credit Risk (1992)
Market Risk (1997)

On and Off Balance Sheet Exposures

Minimum CAR = 8%

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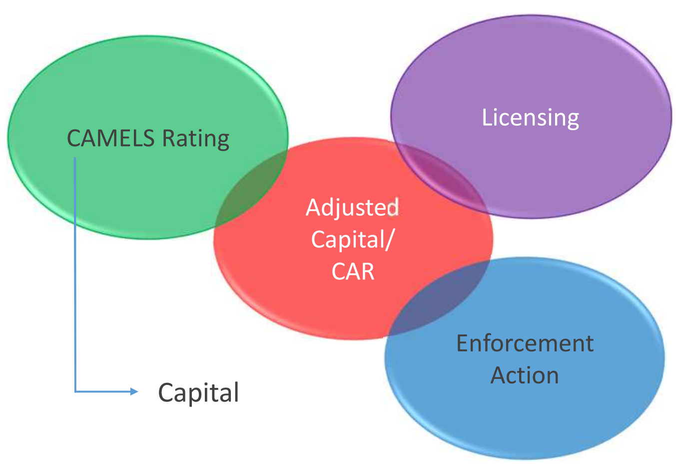
BSP Implementation of Basel I

Banks	Quasi-banks
Circular No. 280 (effective 01 July 2001) – Guidelines on the Adoption in the Philippines of the Risk-based Capital Adequacy Framework (Credit Risk)	**Circular No. 400** dated 01 September 2003 – Guidelines on the Adoption of the Risk-based Capital Adequacy Framework by Quasi-banks
Circular No. 360 dated 03 December 2002 – Guidelines to Incorporate Market Risk in the Risk-based Capital Adequacy Framework	

Minimum CAR required for Philippine banks and quasi-banks = 10% (vs. 8% prescribed by the BCBS)

$$\text{CAR} = \frac{\text{Capital}}{\text{Risk-weighted Assets}}$$

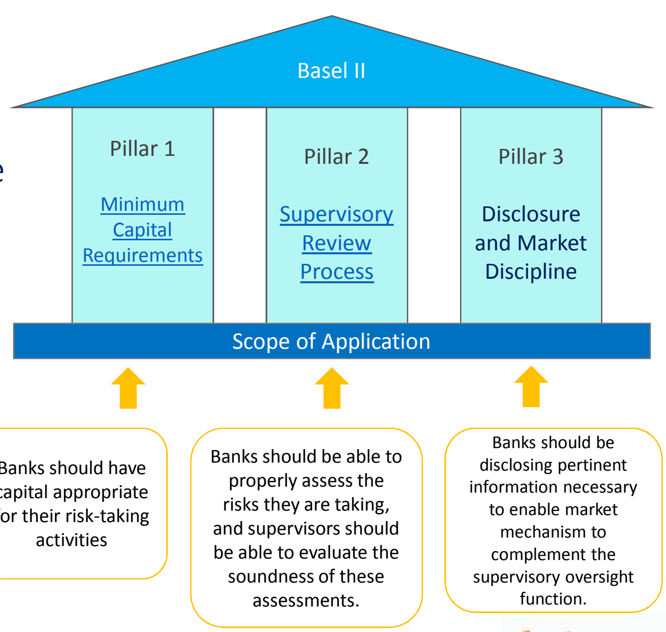
Why should banks comply?



Basel II: The New Capital Framework

- In June 2004, the BCBS published a new capital adequacy framework.
- The new framework was designed to improve the way regulatory capital requirements reflect underlying risks and to better address the financial innovation that had occurred in recent years.
- The changes are aimed at rewarding and encouraging continued improvements in risk measurement and control.

The Three Pillars of Basel II



Underlying Principles

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Basel II

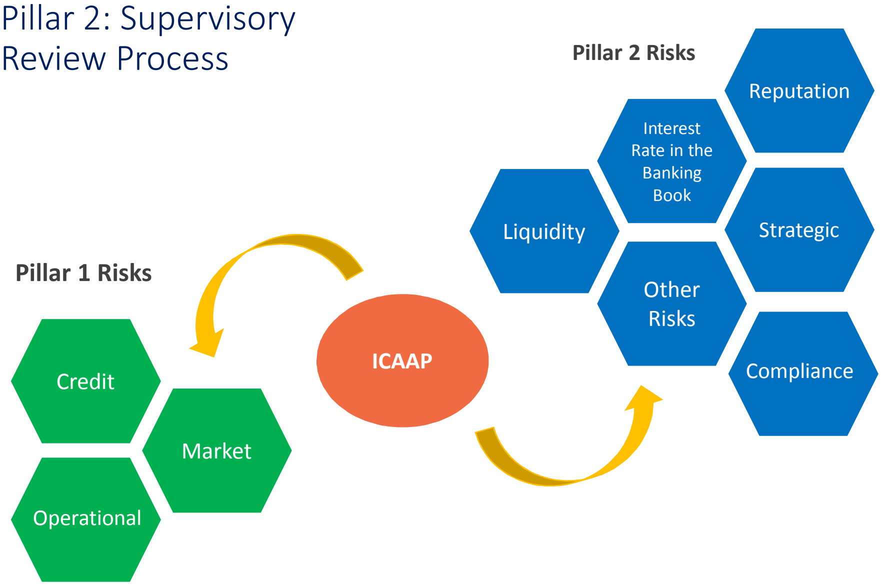
$$CAR = \frac{\text{Capital}}{\text{Risk-weighted Assets}}$$

Menu of Approaches to Capital Charge Computation:

SIMPLE → **COMPLEX**

Credit Risk	Standardized Approach		Internal Ratings-Based Approaches: Foundation IRB	Internal Ratings-Based Approaches: Advanced IRB
Market Risk	Standardized Approach		Internal VaR Models	
Operational Risk	Basic Indicator Approach	Standardized Approach	Advanced Measurement Approach	

Pillar 2: Supervisory Review Process



STRENGTHENING COMPETENCIES IMPLEMENTING CHANGES

BSP Key Issuances on Basel II

Circular No. 538 dated 04 August 2006
Revised Risk-Based Capital Adequacy Framework

Outlines the BSP implementing guidelines of the Basel II

Prescribes the revised computation of CAR which covers the inclusion of the operational risk-weighted assets (RWA) in the total RWA.

Sets enforcement actions for non-reporting of CAR breaches and non-compliance with the required disclosures

BSP Key Issuances on Basel II

Circular No. 639 dated 15 January 2009
Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory Review Process (SRP)

Sets out the guidelines that universal banks and commercial banks should follow in the design and use of their ICAAP.

Outlines the alternative ICAAP methodologies which banks may adopt in lieu of that based on the Risk-based Capital Adequacy Framework.

Sets out the guidelines in the BSP's SRP which covers:

1. The assessment of banks' ICAAP
2. The BSP-bank dialogue
3. The BSP prudential measures

Basel III – The Enhanced Basel Framework

- In July 2009, the BCBS issued a further package of documents to strengthen the Basel II capital framework.
- These enhancements were part of a broader effort to strengthen the regulation and supervision of internationally active banks, in the light of weaknesses revealed by the financial market crisis.

What's New in Basel III?

Capital conservation buffer

An additional layer of common equity that, when breached, restricts payouts of earnings to help protect the minimum common equity requirement.

Countercyclical capital buffer

Places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts.

Leverage ratio

A minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting, divided by the "exposure measure".

What's New in Basel III?

Liquidity requirements

A minimum liquidity ratio, the liquidity coverage ratio (LCR), intended to provide enough cash to cover funding needs over a 30-day period of stress; and a longer-term ratio, the net stable funding ratio (NSFR), intended to address maturity mismatches over the entire balance sheet.

Additional proposals for systemically important banks

Includes requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

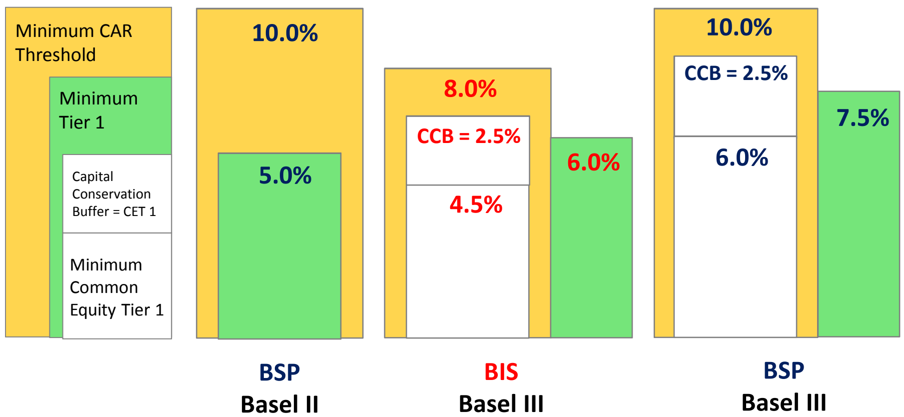
BSP Key Issuances on Basel III

Regulatory Issuance	Subject
Circular No. 781 dated 15 January 2013	Basel III Implementing Guidelines on Minimum Capital Requirements
Circular No. 856 dated 29 October 2014	Implementing Guidelines on the Framework for Dealing with Domestic Systemically Important Banks (DSIBs) under Basel III
Circular No. 881 dated 09 June 2015	Implementing Guidelines on the Basel III Leverage Ratio Framework

BSP Key Issuances on Basel III

Circular No. 781 dated 15 January 2013

Basel III Implementing Guidelines on Minimum Capital Requirements



BSP Key Issuances on Basel III

Circular No. 856 dated 29 October 2014

Implementing Guidelines on the Framework for Dealing with Domestic Systemically Important Banks (DSIBs) under Basel III

- **DSIBs** are financial institutions whose **distress or disorderly failure**, because of their size, complexity and systemic interconnectedness, would **cause significant disruption** to the wider **financial system** and **economic activity**.
- The broad aim of the policies is to reduce the probability of failure of DSIBs by increasing their going-concern loss absorbency and to reduce the extent or impact of failure of DSIBs on the domestic/real economy.

BSP Key Issuances on Basel III

Circular No. 856 dated 29 October 2014 (Continuation)

- The systemic importance of a bank is assessed using an **indicator-based measurement approach.**
- Banks that have a score that exceeds a cut-off level determined using **cluster analysis** shall be classified as DSIBs.
- DSIBs shall be allocated into two buckets with different levels of additional loss absorbency requirements.

Bucket	Additional HLA (CET 1 Capital)
2	2.5%
1	1.5%

DSIBs Framework – Indicator-Based Measurement Approach

Category and Weights	Individual Indicator	Indicator weighting
Size (25%)	Total exposures as defined for use in the Basel III leverage ratio	25.00%
Interconnectedness (25%)	Intra-financial system assets	8.33%
	Intra-financial system liabilities	8.33%
	Securities Outstanding	8.33%
Substitutability/ financial institution infrastructure (25%)	Assets under custody	8.33%
	Payments activity	8.33%
	Underwritten transactions in debt and equity markets	8.33%
Complexity (25%)	Notional amount of OTC derivatives	8.33%
	INMES and UDSCL	8.33%
	Total HFT, AFS, DFVPL less HQLA	8.33%

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BSP Key Issuances on Basel III

Circular No. 881 dated 09 June 2015

Implementing Guidelines on the Basel III Leverage Ratio Framework

- The Basel III Leverage Ratio is designed to act as a supplementary measure to the risk-based capital requirements
- It intends to restrict the build-up of leverage in the banking sector

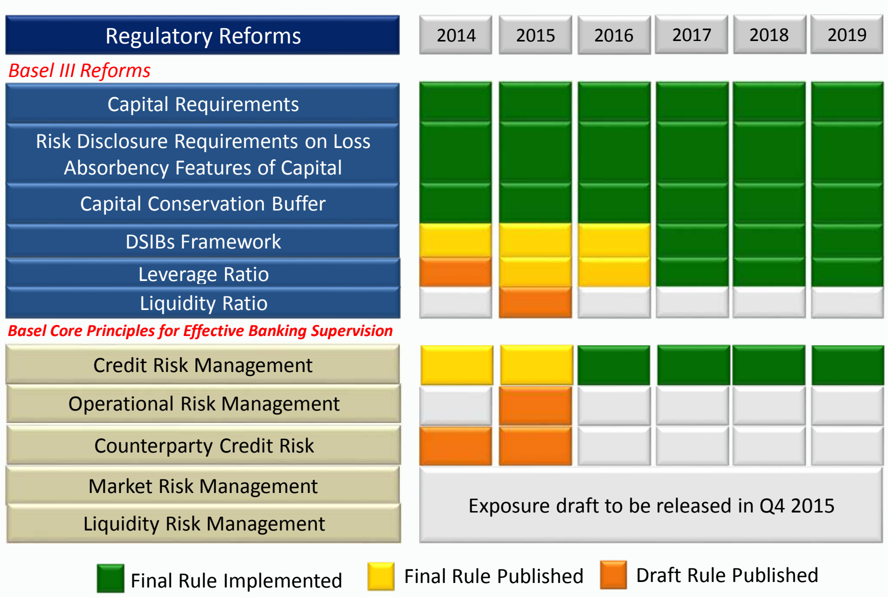
Basel III qualifying capital

$$\text{Basel III Leverage Ratio (\%)} = \frac{\text{Tier 1 Capital}}{\text{Exposure Measure}}$$

Sum of the following:
1. All on-balance sheet items
2. Derivative exposures
3. Securities financing transactions exposures
4. Off-balance sheet exposures

Minimum Leverage Ratio = **5%** (vs. 3% prescribed by BCBS)

BSP Policy Initiatives




Thank
You!