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Annex to press release: Impact of Basel III on Dutch banks significant but manageable

In the quantitative impact analysis conducted at the end of last year by De Nederlandsche Bank (DNB) in conjunction with the Basel Committee on Banking Supervision and the European Banking Authority (EBA, formerly CEBS), it was estimated how much capital and liquidity would need to be built up during the multi-year transition period to the new Basel III supervisory framework in order to meet the new capital and liquidity standards. A total of 25 Dutch institutions participated in the exercise, 18 of which were included in the aggregated results of the Basel Committee and the EBA.

The impact of the new regulatory framework for banks, Basel III, on the Dutch banking system is significant, but still manageable through earnings retention and gradual adjustments to funding profiles. The analysis is based on balance sheet data of December 2009. If, at this moment, we would repeat the impact study, we would see that banks have meanwhile built up capital and liquidity buffers. In a broader sense, banks could also take steps forward by making adjustments to their business models, such as the reduction of risk-bearing activities in their trading books. In the years ahead, DNB will closely monitor and, where necessary, guide banks in the transition towards timely compliance with Basel III.

The impact analysis shows that if Basel III standards were to be applied to the year-end 2009 figures, major Dutch banks would see their most important core capital ratio, the so-termed common equity Tier 1 (CET1), decline from 9.3% to 5.8% (Table 1). Thus, the average capital ratio of major banks still meets the new minimum requirement of 4.5% to be attained by 1 January 2015.

Basel III also introduces an additional capital conservation buffer of 2.5%, which is to be built up gradually from 1 January 2016. To meet this new minimum requirement, major banks would have to raise their capital base by an aggregate EUR 10 billion (Table 2). This can for the greater part be realised by the restructuring of existing instruments that do not meet, or fall just short of meeting, the new quality criteria. Systemically important banks will be subject to additional capital requirements that will be decided on later in the year. For smaller-sized banks, the average capital ratio would decline from 14.5% to 12.3%. Most of them already meet the 7% target ratio, which means that the required build-up of capital by small banks would, in aggregate, be limited. Incidentally, upon introduction of the capital conservation buffer, the assets that no longer qualify as capital will be phased out gradually (grandfathering).

The most important reason for the decline in capital ratios, not only at Dutch banks but also in the rest of the world, is that a stricter definition of capital is now being used. This has, on average, shaved off more than one quarter from the capital buffers of major Dutch banks, a predominant factor being the exclusion of goodwill for regulatory purposes (Table 3). Another reason for the decline in capital ratios is the increase in risk-weighted assets, which results from stricter capital requirements for a number of trading book positions and from more complex activities. Total risk-weighted assets in the Netherlands have increased by more than 15% for major banks and by more than 2% for smaller-sized banks. The stricter capital requirements for counterparty credit risk play an important role here.

Furthermore, Basel III introduces a leverage ratio, a non-risk-weighted measure of assets to capital. As at 31 December 2009, the leverage ratio of major Dutch banks was, on average, 3.2%, that of smaller-sized banks 2.9%. These averages conceal that a number of banks are not yet meeting the minimum leverage ratio of 3%, something that is scheduled to become mandatory as of 1 January 2018.

In addition to the above-mentioned capital requirements, banks are expected to build up additional capital in times of rapid credit growth, the so-called countercyclical buffer. This buffer may rise to the internationally agreed ceiling of 2.5%; its level is determined by the national authorities for exposures to their jurisdictions. The authorities may raise the capital add-on to above the internationally agreed ceiling of 2.5%, if deemed appropriate in their national context. A supervisory authority of a foreign bank does not need to impose this add-on (i.e. above 2.5%) for exposures to the country concerned if the authority itself does not consider such an add-on necessary.

Starting reference point for the countercyclical buffer is an indicator developed by the Basel Committee, linking the buffer to the ratio between lending and national income (credit/GDP). Had the add-on been applied in the past, banks would have been faced with this additional capital requirement for their exposures to the Netherlands from the mid-1990s. Rapid credit growth would even have pushed up the buffer to a level of 2.5% of additional capital. Introduction of the countercyclical buffer does not imply, however, that banks will shortly need to effect a substantial capital increase. The rule under Basel III is that a countercyclical buffer add-on, if any, will start being phased in from 2016, just like the conservation buffer. It may also be noted that, as a result of limited credit growth, the buffer add-on would presently be reduced considerably. Apart from this, it is important to note that the buffer is expressly meant to be drawn down during a crisis. Had the countercyclical buffer been in place in the past few years, the authorities would probably have released it for that purpose.

Finally, Basel III introduces two liquidity standards: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR measures whether banks hold sufficient high-quality liquid assets to withstand a one-month stress scenario. In addition, the NSFR requires a minimum amount of stable funding for longer-term exposures, such as long-term wholesale funding of retail deposits.

The horizon to be taken into account is one year. For major Dutch banks, the LCR would be 81% on average and the NSFR 90% on average, which is close to the average LCR and NSFR of 83% and 93%, respectively, for major banks worldwide (Table 4). The LCR of smaller-sized banks is 161% and their NSFR 98%. These figures do not take account of any surpluses at some banks or of possible shifts, for instance in banks' funding and lending profiles. Indeed, the LCR for the banking system will most probably improve as balance sheet funding becomes more stable due to introduction of the NSFR. Furthermore, the LCR will not come into effect as a minimum standard until 1 January 2015; for the NSFR this is 1 January 2018.

Table 1. Average capital ratios by banking group as at 31 December 2009

	CET1		Tier 1		Total	
	Current*	New	Current	New	Current	New
<i>Major banks</i>						
Netherlands	9.3	5.8	12.0	8.7	14.2	10.8
Europe	10.7	4.9	10.3	5.6	14.0	8.1
International**	11.1	5.7	10.5	6.3	14.0	8.4
<i>Small banks</i>						
Netherlands	14.5	12.3	14.7	12.3	17.2	12.8
Europe	11.1	7.1	10.3	7.6	13.1	10.3
International	10.7	7.8	9.8	8.1	12.8	10.3

* Estimated figures as there is no uniform definition of CET1 under Basel II.

** Europe is not a subset of 'international'. By 'international' is meant the member countries of the Basel Committee.

Sources: BIS, 'Results of the comprehensive quantitative impact study', December 2010; CEBS, 'Results of the comprehensive quantitative impact study', December 2010, and internal calculations.

Table 2. Shortage of qualifying core capital to meet the new requirements as of 31 December 2009 (in EUR billions)

	Required for 4.5% CET1	Required for 7% CET1*
<i>Major banks</i>		
Netherlands	0	10
Europe	53	263
International	165	576
<i>Small banks</i>		
Netherlands	0	0 **
Europe	9	28
International	8	25

* Note: consisting of the minimum capital requirement of 4.5% plus the additional capital conservation buffer of 2.5%.

** Note: these BIS figures do not include all small banks.

Sources: BIS, 'Results of the comprehensive quantitative impact study', December 2010; CEBS, 'Results of the comprehensive quantitative impact study', December 2010, and internal calculations.

Table 3. Impact of new deductions on CET1 capital, percentage changes

	Total percentage reduction in CET1	Goodwill	Other intangibles	Significant holdings of other financial institutions	Deferred tax assets	Mortgage servicing rights*	Excess over 15% limit	Other
<i>Major banks</i>								
Netherlands	-24.4	-6.8	-4.1	-3.3	-2.5	0.0	0.0	-7.6
Europe	-42.1	-19.8	-4.4	-5.0	-6.3	0.0	-1.8	-4.8
International	-41.3	-19.0	-4.6	-4.3	-7.0	-0.4	-2.4	-3.6
<i>Small banks</i>								
Netherlands	-13.5	-4.8	-2.9	0.0	-1.9	0.0	0.0	-3.8
Europe	-33.4	-12.4	-3.1	-8.9	-2.9	0.0	-1.4	-4.7
International	-24.7	-9.4	-2.3	-5.5	-2.8	0.0	-1.0	-3.7

Sources: BIS, 'Results of the comprehensive quantitative impact study', December 2010; CEBS, 'Results of the comprehensive quantitative impact study', December 2010, and internal calculations.

* *Note:* MSR's are non-financial assets that are a by-product of the securitisation process. The seller of the securitised loans retains the right to administer (service) the loans against payment of a fee.

Table 4. Liquidity ratios (as a %)

	LCR	NSFR
<i>Major banks</i>		
Netherlands	81	90
Europe	67	87
International	83	93
<i>Small banks</i>		
Netherlands	161	98
Europe	91	94
International	98	103

Sources: BIS, 'Results of the comprehensive quantitative impact study', December 2010; CEBS, 'Results of the comprehensive quantitative impact study', December 2010, and internal calculations.