

Results of the Basel III monitoring exercise in The Netherlands

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1. INTRODUCTION

This report summarizes the most important findings from the Basel III monitoring exercise. The purpose of this report is to create transparency on the capital and liquidity positions of Dutch banks under the Basel III requirements.

As of the first half of 2011, all Dutch banks have participated in the Basel III monitoring exercise, for which DNB collaborates with the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA). In the second half of 2012, the fourth run of this exercise was held with the reporting date of 30 June 2012.

After a gradual phasing-in, Basel III will be fully implemented in January 2019. The capital and liquidity figures presented in this report are those that would emerge if Basel III would have been fully implemented on 30 June 2012. Against this background, some banks would have to increase their capital and liquidity buffers.

2. NEW CAPITAL REQUIREMENTS

Under Basel III, both the quality and quantity of capital will be improved. This is achieved in two ways. First, the criteria that the supervisor sets on the capital instruments that a bank may hold to meet its capital requirements have become considerably stricter (quality effect). This results in some instruments not being eligible anymore to meet the capital requirements, or that these instruments can only be held in smaller amounts. This effect will decrease the actual capital ratios of banks.

Second, capital requirements themselves will be set higher (quantity effect). In general, the amount of capital to be held per unit of risk will be increased. Yet, the buildup and interaction of the various capital requirements and buffers is often misunderstood. This section therefore presents a summary of the various requirements. Under Basel III, and the implementation thereof in The Netherlands, banks will have to meet all of these requirements:

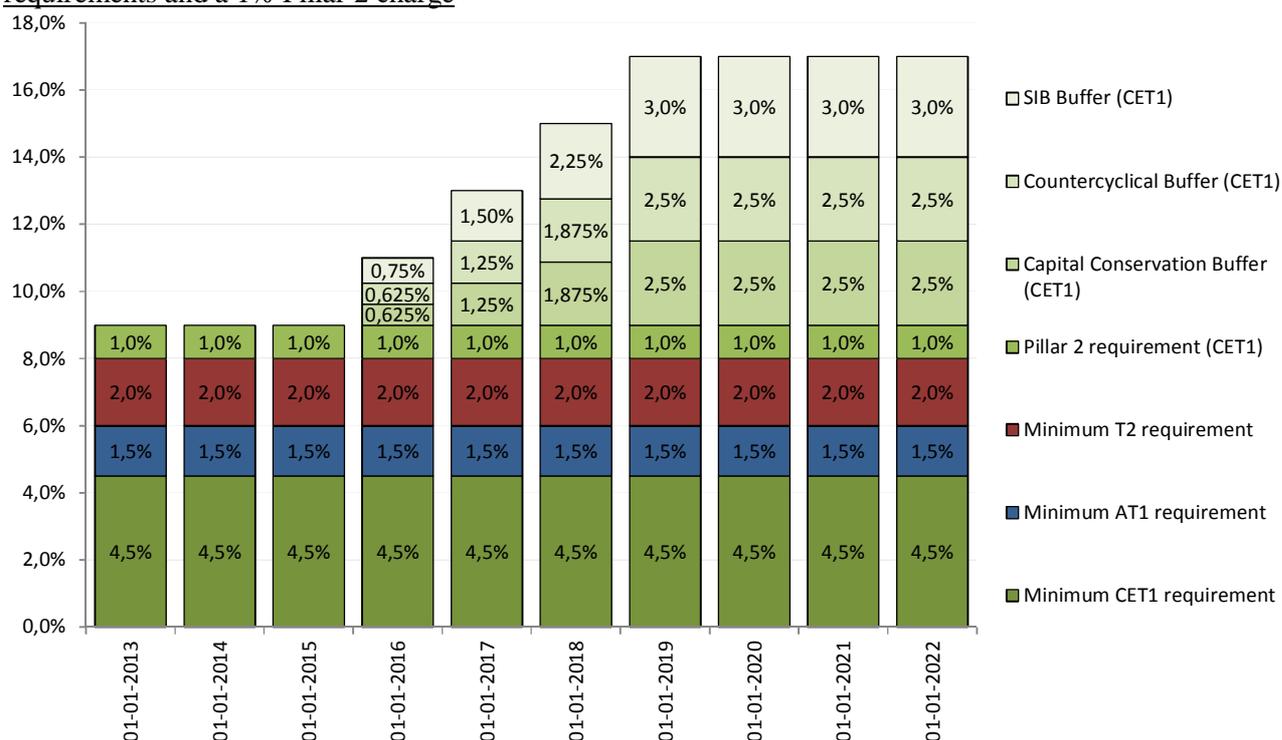
- A minimum Common Equity Tier 1 (CET1) ratio of 4.5%;
- A minimum Tier 1 (T1) ratio of 6%;
- A minimum Total Capital ratio of 8%;¹
- A Pillar 2 requirement, set by the supervisor during the Supervisory Review and Assessment Process;
- An additional capital buffer, consisting of

¹ Tier 1 equals CET1 plus Additional Tier 1 (AT1) capital. Total Capital equals Tier 1 plus Tier 2 capital. For simplicity we assume that a minimum Tier 1 ratio of 6% leads to a de facto requirement of 4.5% CET1 and 1.5% AT1 capital. Similarly, a minimum Total Capital requirement of 8% leads to a de facto requirement of 6% Tier 1 and 2% Tier 2 capital. We will therefore present the three minimum requirements as a de facto 4.5% CET1, 1.5% Additional Tier 1 and 2% Tier 2 requirement, as that is the cheapest way in which a bank can meet the three minimum requirements.

- a conservation component of 2.5%, in CET1 capital;
- a countercyclical component of between 0 and 2.5%, in CET1 capital;
- a systemically important bank (SIB) component of between 0 and 3%, in CET1 capital;
- A minimum leverage ratio of 3%, to be met with Tier 1 capital.²

Figure 1 gives an overview of the phasing-in of the capital requirements along the above calibration, for a bank with the *maximum* countercyclical and SIB buffer charges.³ Since not all banks are subject to the maximum requirements, their actual required capital ratios may be lower than those illustrated in this figure.

Figure 1. Phasing-in scenario of the capital requirements for a bank with maximum capital requirements and a 1% Pillar 2 charge



3. CAPITAL POSITION OF DUTCH BANKS

Banks' Basel III capital ratios⁴ are generally lower than their equivalent Basel II capital ratios. This is because Basel III sets stricter criteria on the eligibility of capital instruments that can be used to meet the requirements.

While lower vis-à-vis the current regime, most banks' Basel III capital ratios have increased gradually over time. The most significant improvement occurred in the first half of 2012. During this period the

² The leverage ratio is a requirement which operates parallel to the above risk-weighted requirements. It is roughly the ratio of Tier 1 capital to unweighted on- and off-balance sheet assets. A bank can meet all risk-weighted requirements, and still be in need of additional capital because it does not meet the leverage ratio requirement.

³ We make two parameter assumptions in the analysis below: 1) we assume that the Pillar 2 requirement is 1% on average for all banks, to be held in CET1 capital, and 2) for the countercyclical and SIB components we use our own internal, non-disclosed estimates.

⁴ Once again, we mean those definitions under the assumption of a fully phased-in Basel III regime.

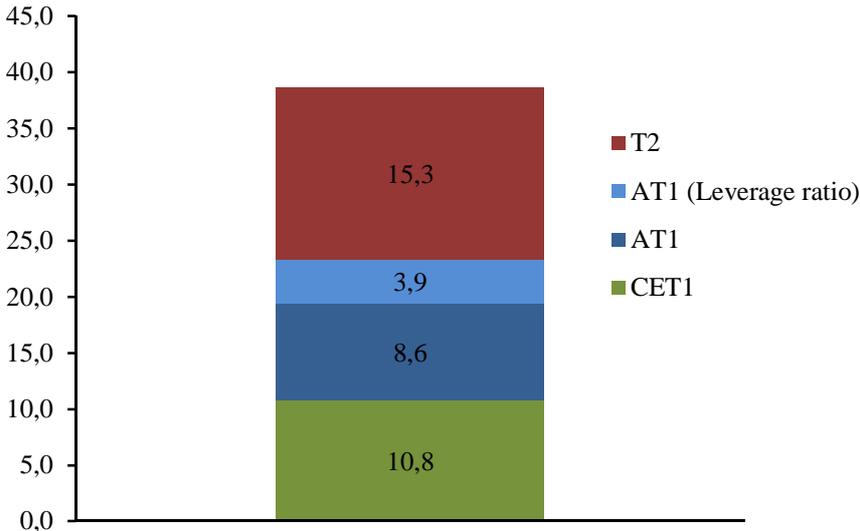
average Basel III CET1 ratio has increased to 10.4% (from 9.5% by end 2011). This ratio assumes that definition which applies when Basel III is fully phased in. In absolute figures, the total amount of Basel III eligible CET1 capital increased by about € 6.7 billion: from almost € 83 billion at the beginning 2012 to almost € 90 billion at mid-year.

The increasing capital ratios are first of all attributable to an increase in eligible CET1 capital. This increase in CET1 capital is due to retained earnings, an increase in other comprehensive income, and regulatory adjustments. While the average Tier 1 and Total Capital ratios have increased to 10.8% and 10.9%, respectively, banks' eligible AT1 and T2 capital amounts show only very little increases. The increase in Basel III capital ratios is to a minor extent caused by a reduction in risk-weighted assets (RWA). On average, RWAs decreased by 0.85% in the first half of 2012 without showing a general trend among banks.

Between 2013 and 2022, the actual CET1, T1 and Total Capital ratios of banks will be higher. This is because until 2022 non-eligible hybrid instruments will be phased out only gradually and hence may be allowed to be part of the AT1 and T2 capital amount until 2022.

The additional amount of capital that banks would have needed to meet the Basel III requirements (including the leverage ratio) on 30 June 2012 is € 39 billion. Figure 2 shows that this amount is divided into a share of CET1 capital, AT1 capital for not meeting the Tier 1 requirement, AT1 capital due to the leverage ratio requirement, and Tier 2 capital. The Tier 2 capital shortfall is caused by the fact that banks currently have only little eligible Tier 2 instruments that they can use to meet the minimum Total Capital requirement of 8%. If the T1 and Total Capital requirements are not met by raising sufficient AT1 and T2 capital, the banks would have to use higher quality CET1 capital to cover those needs.

Figure 2. Total aggregate additional capital (in €billion) needed to meet the Basel III requirements on 30 June 2012.



It should be stressed that the capital buffer (consisting of the conservation, countercyclical and SIB components) is not a 'requirement' in the strict sense. Banks may decide to not hold capital for the full amount of the buffer. However, that will result in (severe) restrictions on the amount banks are

allowed to distribute as dividends and/or bonuses. For simplicity, we therefore assume that banks aim at holding sufficient capital to fully meet the buffer.

The aggregate additional capital requirement may increase if the countercyclical buffer component will increase. Since most economies worldwide are currently in a downturn, the countercyclical buffer component for most banks is fairly low. Currently they hover around 0.5% for a typical Dutch bank. If, for all banks, the relevant countercyclical buffer would have been 1% on 30 June 2012, banks would have needed € 44.5 billion in additional capital, instead of € 39 billion. The rise (of € 5.5 billion) would be almost entirely attributable to an increase in the CET1 shortage. AT1 and T2 shortages would remain unchanged.

Finally, the average leverage ratio of Dutch banks is about 3.3% when measured with 30 June 2012 figures. This is a slight increase over the previous monitoring rounds, where the leverage ratio was just 3% on average.

Several banks have a leverage ratio which is below the minimum of 3%. As a consequence, these banks would have to increase their holdings of T1 capital. The total absolute amount of extra T1 capital attributable to the leverage ratio is about € 6.2 billion. Yet, in some instances these banks also need more capital due to other solvency requirements. In case a bank raises sufficient capital to meet all the above-mentioned risk-based requirements, the Tier 1 capital shortfall that can be solely attributable to the leverage ratio decreases to € 39 billion. That is why the actual shortage due to the leverage ratio is the amount of € 3.9 billion as illustrated in figure 2.

5. LIQUIDITY RATIO

Along with the new rules for capital, Basel 3 also proposed new liquidity requirements to reinforce banks' resilience to liquidity risks. The Liquidity Coverage Ratio (LCR) is a short-term ratio which requires financial institutions to hold an amount of High-Quality-Liquid-Assets (HQLA) at least equal to their net cash outflows over a 30 day stress period. HQLA are a combination of very high and high quality liquid assets that need to be immediately available to the bank.⁵ Net cash outflows are calculated as the difference between assumed drawdowns of deposits (including off-balance sheet commitments) and contractual inflows. The second ratio, the Net Stable Funding Ratio (NSFR), has a time horizon of one year and aims at improving banks' longer-term structural funding.

Based on the initially proposed Basel III liquidity rules text, the average LCR of the Dutch banking sector increased from 97% (end-2011) to 117% (mid-2012) and is therefore well above the minimum requirement of 100%. This implies that there is currently no aggregate liquidity shortfall with respect to the LCR, though there may be shortages on an individual bank basis.

The liquidity buffer of Dutch banks consists mainly of high quality securities and central bank reserves while the in- and outflows are relatively balanced across several items. Total outflows amount to €377 billion while total inflows are € 137 billion. The aggregate amount of HQLA equals € 240 billion, with the share of very high quality assets being 88%.

⁵ Very high liquid assets, so-called Level 1 assets, consist of cash, central bank reserves and debt securities, issued or guaranteed by highly rated public authorities while high quality liquid assets (Level 2) comprise highly rated non-financial corporate and covered bonds as well as certain types of securities. Due to their somewhat lower quality, Level 2 assets can only partially (50% to 85%) be used to cover outflows.

On 6 January 2013, the Group of Governors and Heads of Supervision (GHOS) agreed to a new compromise package which led to changes to several components of the LCR.

The most significant change to the definition of HQLA is the inclusion of certain types of Residential-Mortgage-Backed-Securities (RMBS), while the denominator of the LCR is mainly affected by the lowering of the outflow rate of non-operational corporate deposits. In other words, the GHOS came to the conclusion that certain types of RMBS are of sufficient quality that they can be used (liquidated) by institutions to cover their outflows during stress. The lowering of the outflow rate of corporate deposits means that less corporate clients are expected to withdraw their deposits during stress, making it a more stable source of funding.

The new compromise package of the LCR also includes a gradual phasing-in of the requirement. Banks are required to fulfill an LCR of 60% in 2015 which is gradually increased to 100% in 2019.

The new definitions of the LCR will increase the average ratio of Dutch banks by about 15%. Existing monitoring data, however, does not allow for an exact calculation of the impact of the January 6 changes. While it is straightforward to change the different weightings of in- and outflows, the exact holdings of the “new” HQLA entail a certain degree of uncertainty. In the Basel III monitoring round in the first half of 2013, new data requests should allow an exact calculation of this impact.

Finally, the NSFR of Dutch banks improved in the first half of 2012 from 95% to 98%. Hence, banks are almost compliant with the minimum requirement of 100%. The aggregate NSFR has been relatively stable over time with a slight upward tendency during the last 6 months. Although the NSFR is still subject to negotiations and subsequent changes, the current figures suggest a promising development of Dutch banks’ funding profiles.