THE BASEL COMMITTEE SEEKS COMPROMISE IN THE DEBATE OVER CAPITAL VERSUS ECONOMIC GROWTH

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To Our Clients and Friends:

On Sunday, the Basel Committee on Banking Supervision ("Basel Committee") announced its proposed increases to the capital ratios that apply to banks, as well as the transition periods for banks to comply with the new standards. This announcement follows the Basel Committee's December 2009 capital and liquidity proposals, described in detail in the January 2010 Debevoise & Plimpton Financial Institutions Report, the Committee's revisions to the proposals in July, and its evaluation of the possible economic impact of increased capital ratios in August. The Basel Committee is seeking to resolve major issues relating to the proposals in time for them to be formally endorsed by the G-20 leaders at their meeting in Seoul, South Korea on November 11 and 12. The contemplated capital ratios, although a significant increase from those historically required for banks (particularly in Europe), are not as severe as some in the industry had feared. The capital ratios, along with the complex transition periods, which are described below, appear designed to mitigate potential damage to national economies from the new standards. Signaling that further significant developments on this matter are still to come, however, the Basel Committee announcement declares that "[s]ystemically important banks should have loss absorbing capacity beyond the standards announced" on Sunday.

As to the capital requirements, the Basel Committee ultimately will require banks to maintain: (i) a minimum common equity capital ratio of 4.5%, (ii) a minimum Tier 1 capital ratio of 6% and (iii) a minimum total capital ratio of 8%. The minimum common equity ratio is a new requirement to ensure that banks maintain more core capital, which is fully able to absorb losses, than many banks held prior to the crisis. In addition, the Basel Committee ultimately will require a "capital conservation buffer" of 2.5%. This capital conservation buffer is not part of the minimum requirements; but if a bank does not hold capital in excess of this buffer, its ability to pay dividends and discretionary bonuses and engage in stock repurchases will be limited. In order to operate without such limits on earnings distributions, after adding in this buffer, the bank will have to maintain common equity, Tier 1, and total capital ratios of 7%, 8.5% and 10.5%, respectively. The Basel Committee announcement also makes clear that another "countercyclical" buffer (the application of which was not agreed upon but left to individual country discretion and which would be used by a country's regulators when they fear their economy is experiencing excessive credit growth), could, if implemented, add up to yet another 2.5% to such ratios. Finally, the announcement also confirms that these risk-based ratios are to be supplemented by a leverage ratio, with a 3% leverage ratio being the initial proposal.

With respect to timing, the Basel Committee phased in the three basic minimum requirements first, with a longer period for banks to comply with the capital conservation buffer and other requirements. By January 1, 2013, banks must meet a 3.5% common equity capital ratio, which will increase in annual fifty basis point increments to 4.5% by the beginning of 2015. Required Tier 1 capital increases from 4.5% on January 1, 2013 to 6% on January 1, 2015. The minimum total capital ratio remains unchanged at 8%. Presumably to reduce the economic impact, the Basel Committee does not require banks to begin to meet the capital conservation buffer until January 1, 2016, when that buffer will add 0.625% to the three basic ratios, and then increase by similar increments year over year until it reaches the maximum of 2.5% in January 2019. The phase-in of deductions from common equity (*e.g.*, for investments in financial institutions, mortgage servicing rights and deferred tax assets) would proceed by 20% annual increments beginning in January 2014. Moreover, while the definition of common equity would be set as of January 1, 2013, the removal of instruments that no longer qualify as non-common equity-based Tier 1 or Tier 2 capital would be phased in over a ten-year horizon beginning in 2013. Finally, as to the leverage ratio, the Basel Committee contemplates supervisory monitoring of the ratio in 2011 and 2012, a parallel run testing period at 3% from 2013 to 2017 (with disclosures required in 2015), and any adjustments completed in time for it to be a capital component by 2018.

While the focus of the announcement was on the capital enhancements, the Basel Committee also addressed its December liquidity proposals. As discussed in detail in the January Financial Institutions report, the liquidity proposals consist of two components: the liquidity coverage ratio ("LCR"), a short-term standard, and the net stable funding ratio ("NSFR"), which seeks to change more structurally a bank's balance sheet in terms of liquidity. The Basel Committee stated that it plans to observe banks' LCR-related indices beginning in 2011, and then formally introduce an LCR requirement in January 2015. The NSFR, which was more roundly criticized by the banking industry in the comment process, is expected to be implemented by 2018.

As with other Basel directives, these will not be self-effectuating, but rather a country must adopt them by legislation or regulation to be imposed upon that country's home banks. To mitigate concerns that some countries might make the rules more lenient as the higher ratios become effective, the Basel Committee release provides that member countries should adopt the rules implementing the standards by January 2013. Throughout the process, many Europeans have expressed particular concern that the United States might not fully implement Basel III, just as the U.S. had strongly promoted the development of Basel II and then only partially implemented those final rules (compelling only the largest and most internationally active U.S. banks to adopt the Basel II advanced approach). Compounding the concern is the widely reported view that European banks will generally face greater pressure to generate capital under these proposals than their U.S. counterparts. Just last week, Deutsche Bank announced a major offering which many consider to be at least partly in preparation for these higher standards.

Presumably to alleviate such concerns promptly after the Basel Committee announcement, the U.S. federal banking agencies released a joint statement endorsing the Committee's efforts. Notably, the U.S. banking agencies' release specifically stated support for the actions of the Basel Committee to "strengthen the position of large and internationally active banks." The Basel announcement, on the other hand, provided that "systemically important banks should have loss absorbing capacity beyond the standards announced today," and historically Basel Committee capital directives often have applied more broadly to European banks. This raises a question as to whether, like Basel II, only a subset of the largest U.S. banks will be subject to the new Basel standards, with a broader range of European banks subject to them. Another question principally for U.S. banks is whether the mandates of the Dodd-Frank Act for systemically significant banks to meet enhanced capital, liquidity and other requirements will be set equal to, or in addition to, whatever additional prudential burdens the Basel Committee imposes in the future. If timing, political or other issues cause the U.S. regulators to move first or to establish rules under Dodd-Frank not mandated by the Basel Committee, the largest U.S. banks could be at a competitive disadvantage to their non-U.S. counterparts in this regard.

As a result, while the Basel Committee's most recent announcement seeks to show that the G-20 can achieve its goal of international uniformity of fundamental banking rules, whether such uniformity survives country-specific implementation by 2013, let alone the lengthy transition period, remains to be seen. The crisis has reminded the world that banks are a crucial economic engine (positively or negatively) for a country and despite strong comments by the G-20 leaders, politics remains local. Nonetheless, Sunday's announcement cannot be viewed in isolation. Rather, many of the largest financial institutions are appropriately evaluating the cumulative impact of these capital (and ultimately liquidity) increases; the new Basel rules for trading, derivative and securities finance activities coming into effect at the end of 2011; and the additional burdens to be imposed under Dodd-Frank. We already have witnessed sales of asset management and private equity businesses and announcements of reduced or terminated trading operations as institutions re-evaluate the benefits and burdens of their different businesses in the new environment.

Please feel free to contact us with any questions.

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