Basel III Capital Requirements

Accounting / Tax implications

P. R. Ramesh

CAFRAL Seminar on Basel III
Capital requirements
4 July, 2014

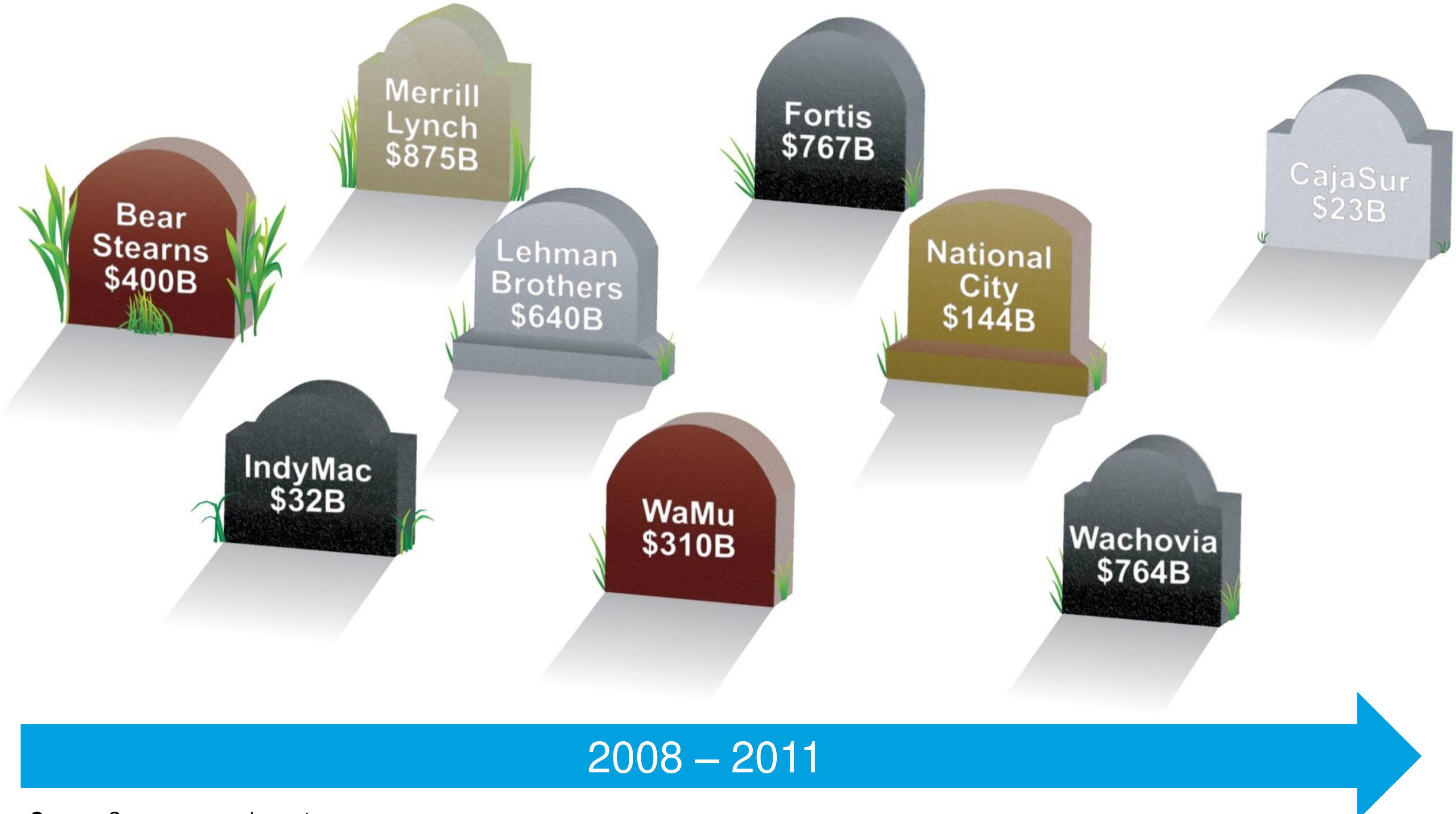
Contents

Overview

Evolution of Risk and Capital Guidelines - Globally

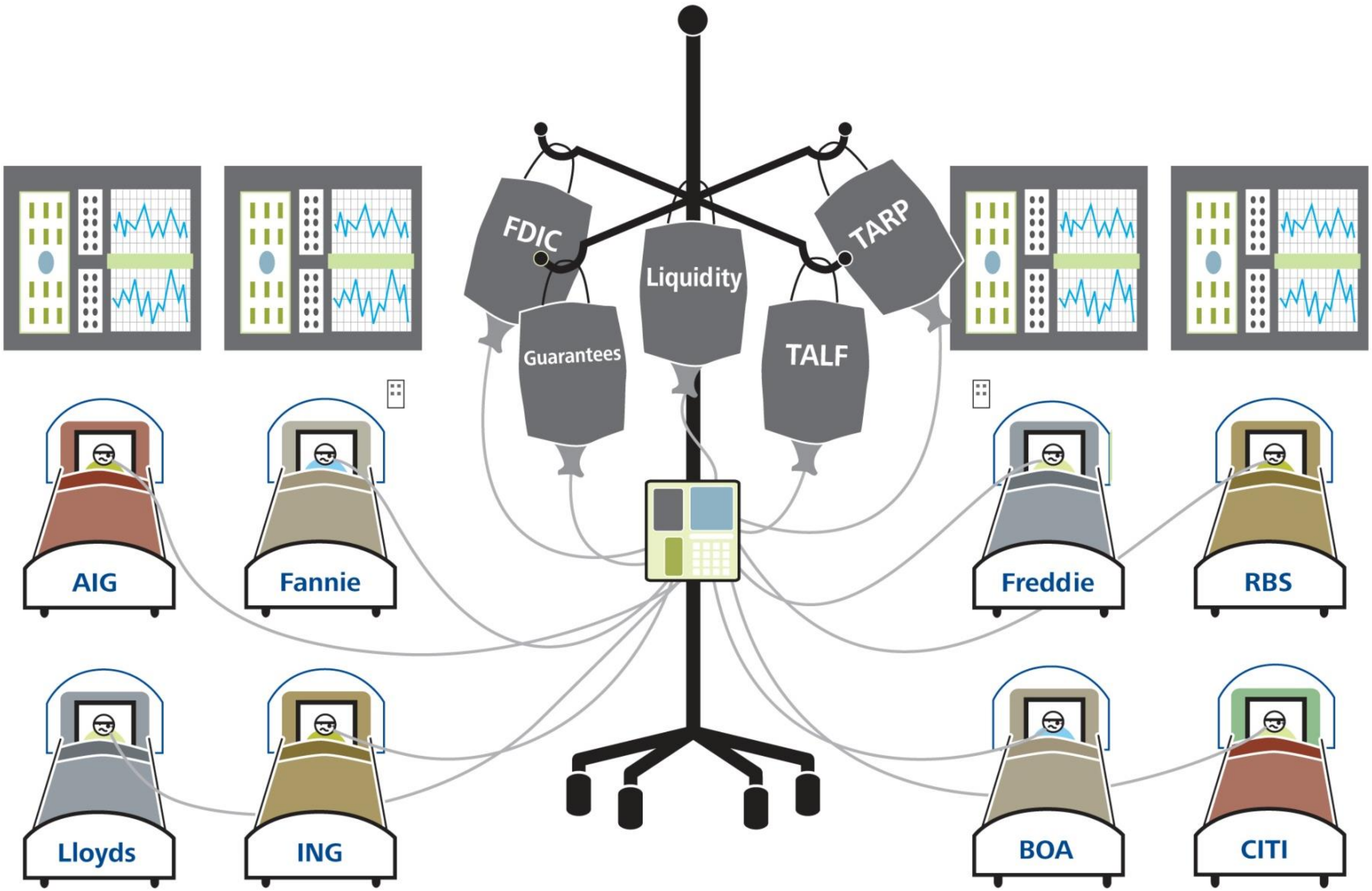
Before 1988	1988 - 1996	1988 - 2004	1988 - 2004	2004 - 2009
Before Basel	**1988: Basel I**	**1996: Basel I modified**	**2004: New Capital Adequacy framework**	**2009: Basel II framework modified**
• No standardization of measures • Ratios employed: ratios of capital-total deposits/assets, and leverage ratio	• Basel I guidelines introduced • Central focus on Credit Risk • International standardisation with common definition of Capital and • Standiardisation of measures	• Basel I norms modified to include Market Risk arising from banks' open positions in foreign exchange, traded debt securities, traded equities, commodities and options	• Basel II guidelines issued • Introduced capital requirement for operational risk management • Also inlcuded guidelines for supervisory review process and market discipline	• Revisions to Basel II capital framework proposed: – Changes to capital requirements for complex and illiquid credit products certain complex securitizations and exposures to off-balance sheet vehicles

The graveyard



Source: Company annual reports
Note: Asset values represents last quarterly earnings report before the bank failed
.

The intensive care unit



Reasons That Spawned Basel III (Issues With Basel II)

- **Over-reliance on rating agencies** - inadequate for asset securitization and related structured products transactions
- **Underestimated risks –** underestimated tail risks and counterparty credit risk in trading activities
- **Lack of standards to manage liquidity risks –** no specific rules to limit liquidity risk and liquidity crunch hit the banking industry widely unprepared
- **Flawed calibration of various risk factors -** Regulator's assessment of risk factors and their correlation was not conservative enough
- **Governance weaknesses -** lack of strong senior management led risk culture in banks
- **Weak implementation of pillar 2 –** weak stress testing and capital planning
- **Procyclical effects of Basel II –** default risk positively correlated with business cycle
- **Parts of markets lacking regulation -** insufficient regulation in some key market areas, such as securitization, CDS, hedge funds, Structured Investment Vehicles and credit origination
- **Varying implementation timelines** - financial institutions in several large economies, notably the US were not subject to Basel II at the time of the financial crisis

Evolution of Risk and Capital Guidelines for Banks - Globally

Dec 2010

Basel III

- Committee released Basel III, which set higher levels for **capital requirements and introduced a new global liquidity framework**
- Committee members agreed to implement Basel III from 1 January 2013, subject to transitional and phase-in arrangements

June 2011

Revision to Basel III

- Revisions to the Dec 2010 guidelines were published after feedback from regulators and banks

Nov 2011

Assessment of G-SIBs

- The Committee published the rules text that sets out the **framework on the assessment methodology for global systemic importance** and the magnitude of additional loss absorbency that **global systemically important banks (G-SIBs**) should have

Jan 2013

Revised LCR

- The Basel Committee issued the full text of the revised **Liquidity Coverage Ratio (LCR)**. The LCR underpins the short-term resilience of a bank's liquidity risk profile. The LCR will be introduced as planned on 1 January 2015 and will be subject to a transitional arrangement before reaching full implementation on 1 January 2019

Jun 2013

CCP capital requirements

- BCBS, in cooperation with the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commission (IOSCO), is seeking views on potential changes to the **capital treatment of banks' exposure to central counterparties (CCPs)**
- Methodology for assessing and identifying G-SIBs. It also describes the **additional loss absorbency requirements that will apply to G-SIBs**

Jan 2014

Consultative document of NSFR

- Consultative document on revisions to the securitization framework
- Consultative document on Net Stable Funding Requirements (NSFR)
- Framework and disclosure requirements for Leverage Ratio

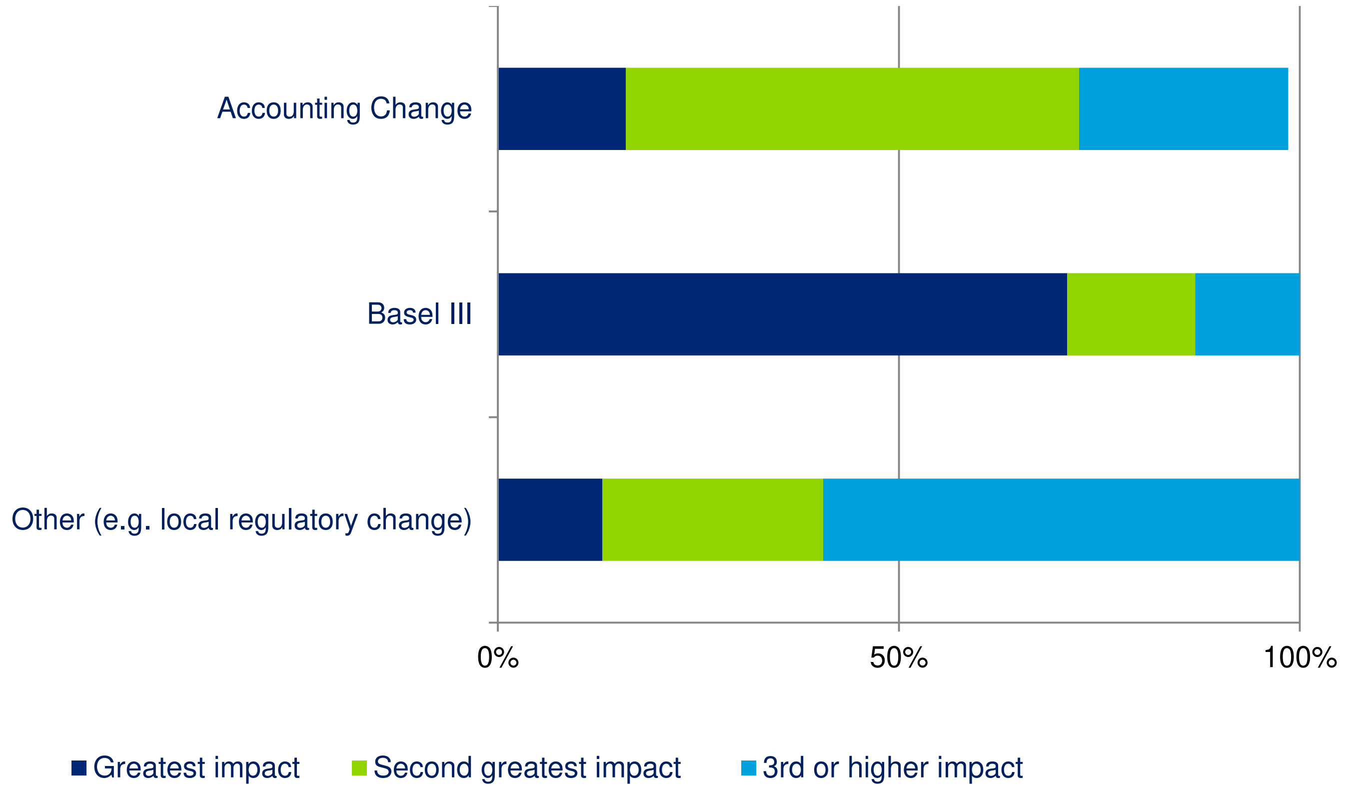
Survey results on Basel III

While less than 20 percent report Basel III work is complete, 59 percent currently meet Basel III minimum capital ratios and an additional 22 percent expect to do so well before deadlines. Many institutions are using this opportunity to rethink their business strategy.

Which strategic actions has your organization taken, or is it intending to take, to mitigate adverse capital impacts from Basel III?

Source: Deloitte Global Basel III suvery 2013

Which of the following do you expect to have the greatest impact on your organisation over the next 5 years?



Source: Global IFRS Banking Survey January 2013

Impact on Accounting change would significantly increase once India converges with International Accounting Standards

Basel III in India

RBI Vs. Basel Committee

- While RBI endorses most of Basel III proposals, they are **more stringent** than the proposed guidelines of the Basel Committee on Banking Supervision in the terms of:

  - **Higher requirement of common equity capital**: RBI's requirement for common equity is 1% higher than what BCBS proposes (5.5% compared to 4.5%)
  - **Stricter leverage ratios**: RBI has proposed a leverage ratio of 4.5% as compared to 3% proposed by BCBS

- In addition, some Basel III proposals are **not addressed** in the current guidelines:

  - **Advanced approaches** (internal models) approach for Credit Valuation Adjustment (CVA) and Counterparty Credit Risk (CCR) is not prescribed. RBI only proposes the standardised approach
  - **Countercyclical Buffer(CCB):** The commonly used indicators, including the ratio of credit to GDP, may not be suitable for India and RBI is working on a combination of qualitative judgment and quantitative indicators for assessing the requirement for the buffer
  - **Basel III's Liquidity risk proposal**: RBI has not issued guidelines on Net Stable Funding Ratio(NSFR) even as Liquidity Coverage Ratio (LCR) and other monitoring tools are adopted
  - **Wrong way risk:** guidelines do not address wrong way risk

Summary
Basel III Requirements

Enhance quality of capital

- Common Equity(“predominant”)
- Additional Tier 1 capital
- Tier 2 Capital
- Deductions amended

Liquidity Coverage Ratio

$$\text{Liquidity Coverage Ratio} = \frac{\text{Stock of HQLA}}{\text{Net Outflows over 30 day}} \geq 100\%$$

Increase regulatory capital

- Common Equity ≥ 5.5 %
- Tier 1 Capital ≥ 7 %
- Total Capital ≥9 %

$$\text{CRAR} = \frac{\text{Capital}}{\text{Minimum Capital Requirements}} \geq 9\%$$

Leverage ratio

$$\text{Leverage Ratio} = \frac{\text{Capital}}{\text{Exposure}} \geq 4.5\%$$

Capital Buffers

- Capital conservation buffer
- D-SIB Buffer

Credit and market risk requirements

- Higher RWA for securitization related exposures and exposure to central counterparties

**target ratios*

Transition Period
Implementation timetable of Basel 3 requirements

	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity Tier 1 (CET 1)	4.5%	5.0%	5.5%	5.5%	5.5%	5.5%	5.5%
Capital Conservation Buffer				0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer	4.5%	5.0%	5.5%	6.125%	6.75%	7.375%	8.0%
Phase-in of deductions from CET1	20%	40%	60%	80%	100%	100%	100%
Minimum Tier 1 capital	6.0%	6.5%	7.0%	7.0%	7.0%	7.0%	7.0%
Minimum Total Capital	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Minimum total capital plus conservation buffer	9.0%	9.0%	9.0%	9.625%	10.25%	10.875%	11.5%
Liquidity Coverage Ratio			60%	70%	80%	90%	100%
D-SIBs (for highest bucket) – *Draft Guidelines*				.20%	.40%	.60%	.80%

Key Challenge: Alignment of Accounting and measurement transitions upon convergence with IFRS with the Basel III transition

Regulatory Adjustments

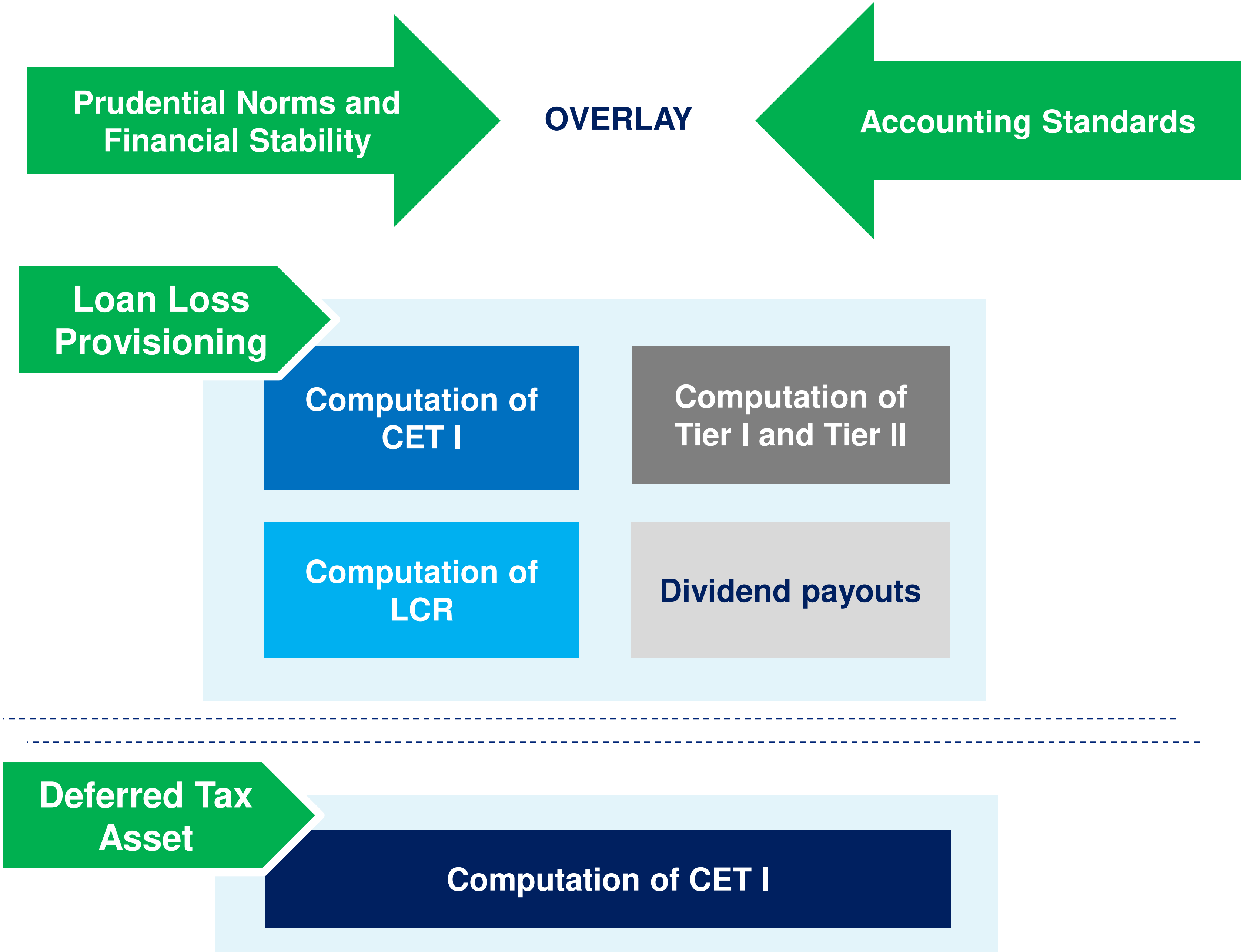
ITEMS	DETAILED REGULATORY ADJUSTMENT	Likely impact
Goodwill and other intangibles	• Deducted from CET 1 • Including goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities outside the scope of regulatory consolidation	• **Potentially Significant**
Cash flow hedge reserve	• Amount of cash flow hedge reserve relating to hedging of items not fair valued on the B/S (including projected cash flow) derecognised in CET 1: deduction of positive amount and adding back of negative amount	• **Depends on the size of the cash flow hedge reserve**
Shortfall of the stock of provisions to expected losses	• Deduction of full amount from CET 1, not reduced by any tax effects expected	• **Impact only on IRB Banks**
Gain on sale related to securitisation transactions	• For Banks which follow the accounting standard that recognises the gains at inception, the following guidelines apply: • Derecognise in CET 1 of any increase in equity resulting from securitisation transaction such as that expected future margin income resulting in a gain-on-sale • For all other Banks which follow the amortise method, since gain on sale is not deducted, there is no deduction	• **None in Indian context**
Deferred tax assets	• Existing Basel II guidelines have been retained except that the deduction will be from CET1 instead of Tier I	• **Potentially Significant**

Regulatory Adjustments

ITEMS	DETAILED REGULATORY ADJUSTMENT	Likely impact
Defined benefit pension fund assets and liabilities	• Defined benefit pension fund liabilities fully recognised in CET1 (i.e. no deduction) • Deduction of defined benefit pension fund assets from CET1, net of any associated liabilities	• **Limited**
Investments in own shares (treasury stock)	• In India, banks' should not repay their equity capital without specific approval of Reserve Bank of India. • Incase of indirect exposure through mutual funds and index funds, identify exposures to own shares and deduct from Common Equity Tier 1 capital. Similar exposures to AT1 and T2 should also be identified and deducted from corresponding tiers.	• **Limited**
Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities	• Derecognised in the calculation of CET1	• **None in Indian context**

Focus of our discussion

Focus of our discussion



Prudential Norms and Accounting Standards

	Accounting Standards	Prudential Norms
Objective	• Transparency and Fairness	• **Financial Stability and Resilience**
Scope	• Firm-specific valuation of assets and provisions based on accounting standards	• **Micro-prudential approach with a Macro-prudential overlay**
Stability	• Accounting standards contribute to financial stability by avoiding "artificiality"	• **Set capital standards liquidity norms and disclosures for stability**

Work in close cooperation to set international standards and shape the global regulatory reform agenda

Accounting Implications

International Accounting support for prevention of future financial crisis situations

Typical failures which led to the recent banking crisis

- Excessive **on- and off-balance sheet leverage** in the banking sector
- Belief in infinite and permanent **liquidity**
- **Focus on revenues,** not on related risks
- Low level and quality of banks' **capital basis**
- **Pro-cyclical deleveraging**
- Lack **of common language** between decision-makers and technical staff

Some answers of the accounting bodies:

- New rules for **classifying** and **measuring Financial Instruments**
- Switch from incurred **to expected loss models**
- Stronger **link** between **Hedge Accounting** and **Risk Management**

- Potential **increase** of **consolidated entities**
- **Comprehensive reporting requirements** about consolidated and non-consolidated entities

Road Ahead – Significant developments in global accounting standards

1. Replacement of IAS 39 with IFRS 9
2. Convergence between FASB & IASB
3. New standards especially IFRS 9 to IFRS 13
4. Thrust towards fair value accounting

Progress so far..

- Currently more than one hundred countries are using IFRS
- Half of the Fortune Global 500 companies now report using IFRS
- Recently Russia, Mexico, Brazil, Canada & Korea have adopted IFRSs
- Post Implementation Review of major standards two years after they have come into effect as enhancement to due process

Proposed roadmap for IFRS convergence in India

ICAI has released a summary of its recommendations on the timetable for the adoption of Indian Accounting Standards which are largely converged with International Financial Reporting Standards (IFRSs).

The ICAI recommendations, which will be considered by the Indian Ministry of Corporate Affairs (MCA) in determining its final decision on implementation, propose that listed and large entities should mandatorily apply Ind AS in consolidated financial statements for accounting periods beginning on or **after 1 April 2016.**

The roadmap for financial institutions and insurance companies will be determined in a separate process, in consultation with the Reserve Bank of India (RBI) and the Insurance Regulatory and Development Authority (IRDA).

Current Accounting Practices in India

Indian banks currently make the following types of loan loss provisions:

Type of provision	Treatment – Basel II	Treatment – Basel III
General provisions for standard assets	Include as part of Tier II	
Floating provisions	Include as part of Tier II	
Specific provisions for NPAs	Cannot include as Capital	
Provision against diminution in fair value of a restructured asset	Cannot include as Capital	

Drawbacks of present provisioning policy:

1) No scientific method for General provisions
2) Makes inter-bank comparison difficult
3) Lacks countercyclical elements

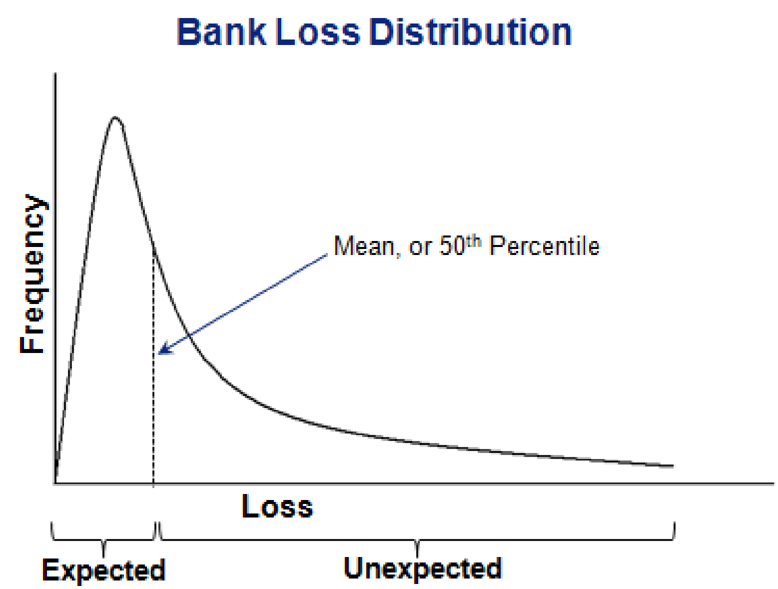
Rule based prudential norms prescribed by the regulator

Especially impairment under IFRS and the Capital requirements from Basel are closely linked

- Basel addresses capital requirements which provide coverage against “unexpected losses”
- IFRS addresses revenue recognition which includes loan loss reserves to provide coverage against “expected losses”

Two Dimensions of Risk

IFRS	**Basel**
Expected Losses	Unexpected Losses/ Volatility
Anticipated and specifically planned for	Unanticipated but inevitable
Accounted for in ALL	Requires capital protection (Economic and Regulatory Capital)
Income Statement	**Balance Sheet**



Interface with IFRS

As per existing practice Revaluation reserves are recognised for CRAR with a “haircut” & is part of Tier II capital

As per Basel III Revaluation reserves+ other unrealised gains which are part of OCI are included in Core Equity Tier I capital

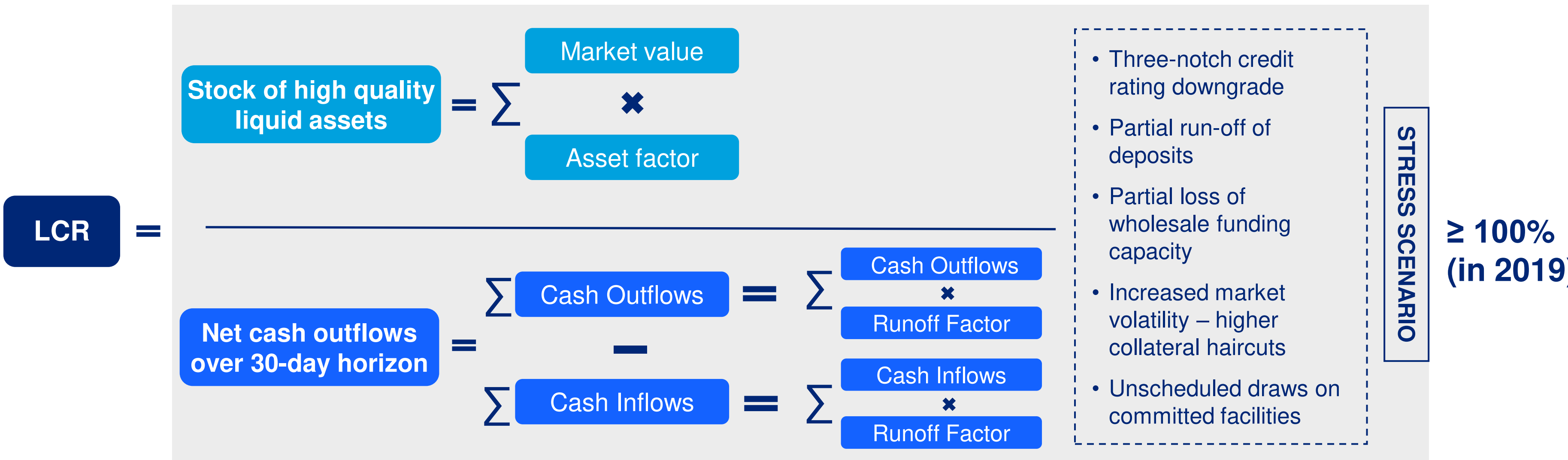
This is not in sync with prudential aspects -- (In India will be in Tier 2 at 55% discount)

Interface with IFRS

Offsetting Requirements

	Current requirements		Basel III
	IFRSs	US GAAP	
Number of counterparties	Two or more	Only two	Two
Ability to set-off?	Unconditional	Conditional (as well as unconditional)	Has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt
Intent to set-off?	Required (Settle net or simultaneously)	Not required for certain instruments (some derivatives, cash collateral, repos / reverse repos)	Implicitly required by requirements that specify that the exposures are controlled and monitored on net basis
Offsetting required when criteria are met?	Required	Optional	If conditions are met parties may net for computation of capital adequacy
Focus	Cash flows	Credit risk	Net exposure

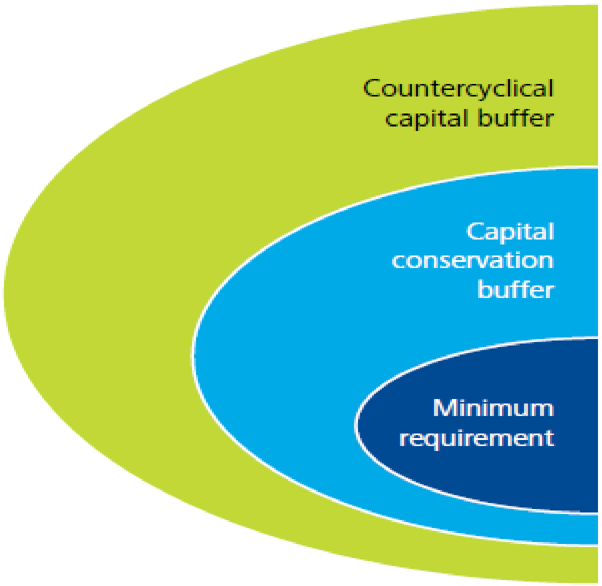
Computation of Liquidity Coverage Ratio



- **With increasing impaired assets and NPAs, the contractual inflows (with run-off of 50%) are affected thereby increasing denominator and reducing the LCR**

- Additionally, other assets (with run-off of 100%) under cash inflows will also come down further impacting the LCR

Dividend payouts and Loan Loss Provisioning



- The amount of capital sufficient to protect the banking sector from periods of excess aggregate credit growth associated with the build up of system-wide risk **(Not implemented in India)**

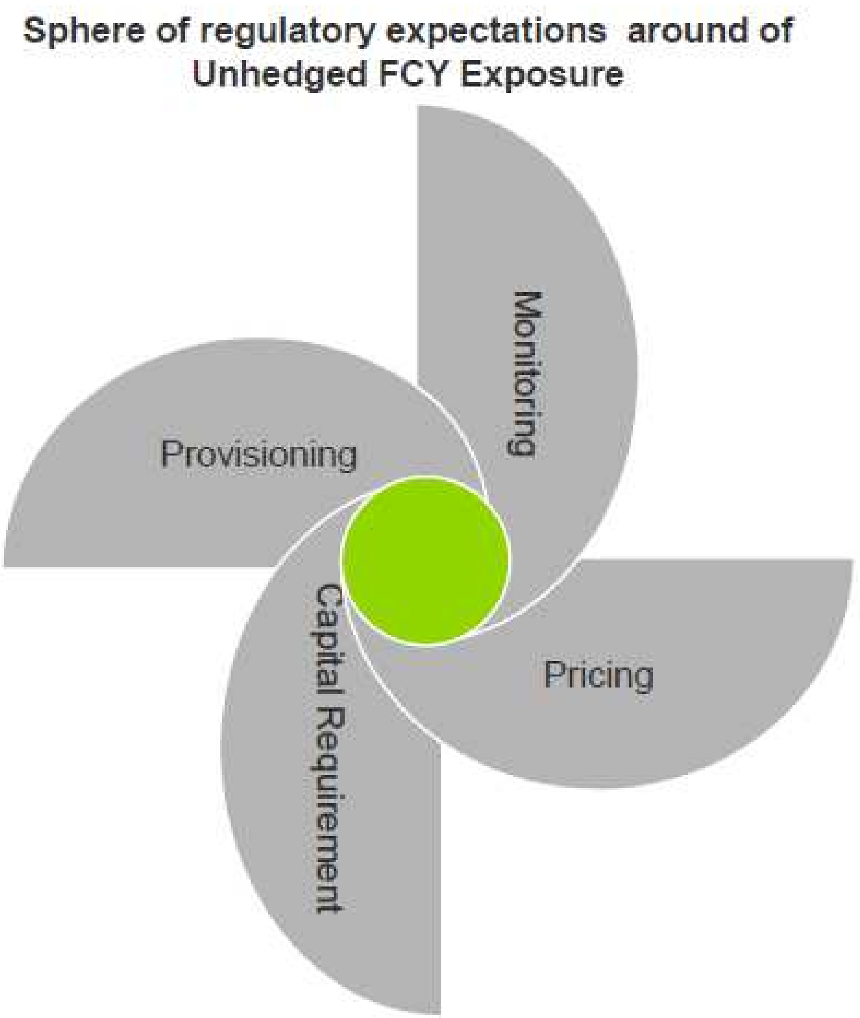
- The amount of capital sufficient for the bank to withstand a significant downturn period and still remain above the Minimum Capital Requirement

- The amount of capital needed for a bank to be considered as a viable going concern by creditors and counterparties

- Basel III requires Banks to keep a buffer of 2.5% of CET I as Capital Conservation Buffer (CCB)
- **When the bank faces stress through increased levels of impairment losses, banks are allowed to dip into their CCB**
- **Whereby institutions will be restricted from making capital distributions and dividend payments where capital levels dip into the buffer range.**
- The restrictions increase as the institutions approach the minimum capital requirements

Unhedged Foreign Currency Exposure (UFCE)

- UFCE of an obligor heightens the credit risk of a bank when the FCY markets are in turmoil.
- Recent guidelines aim to discourage the banks from lending to obligors who do not have adequate hedging
- Methodology prescribed for computing incremental provisioning and capital requirements
  - Ascertain the amount of UFCE
  - Estimate the probable loss
  - Estimate the riskiness of the UFCE



Issues and Challenges

1. Completion of conceptual framework – the philosophical & methodological underpinning of the work of IASB
2. Frequent criticism that fair value accounting lead to inappropriate recognition of unrealised profits
3. While fair values are often seen to be synonymous with exuberance, in IFRS 13 risk adjustments are required when fair values are measured using mark-to-model techniques
4. Legitimate requests of many EMEs –Agriculture accounting, foreign currency translation
5. Application of professional judgement is very crucial but in many cases judgement is little more than an educated guess

Tax Implications

Analysis of banks

- Average effective tax rate [ETR] of 14 PSU and private sector banks for 2011-12:

ETR	29.8%
ETR (excluding provision for earlier years)	30.8%
Current tax	28.8%

- Net DTL constituted 3.78% of the tax liability
  - In absolute terms, deferred tax constituted 9.15% of the tax liability

- Primary reason for lower current tax vis-à-vis statutory tax rate (32.45% in FY 2011-12) are permanent differences:
  - Exempt income like dividend, interest, etc. (net of disallowance for expenses)
  - Special Reserve under section 36(1)(viii) for providing long-term finance for industrial or agricultural development, infrastructure facility development and housing development
    - RBI vide Circular dated 20 December 2013 advised banks to create DTL – no longer a permanent difference but a timing difference
    - Entire Special Reserve can be reckoned for Tier I capital in terms of the Circular

Basel III may not have a direct impact on current tax

Issuance of capital instruments

- One of the key tax issues to be addressed is implications arising from issuance of instruments to comply with Basel III norms
  - Instruments could form part of Additional Tier 1 Capital or Tier 2 Capital

- Tax issues in India will depend on the nature of capital instruments issued by banks

- RBI has permitted 'tax event' calls in respect of Additional Tier 1 Capital or Tier 2 Capital instruments, subject to conditions
  - RBI will grant permission only if it is convinced that the bank was not in a position to anticipate the events at the time of issuance of the instrument
  - Example: Call option can be exercised pursuant to change in tax treatment which makes the capital instrument with tax deductible coupons into an instrument with non-tax deductible coupons; to be replaced with capital instrument having tax deductible coupons

UK tax authorities (HMRC) set up a Basel III Working Group to deal with the tax treatment of regulatory capital instruments

Deferred tax

RBI guidelines

- The DTAs computed as under should be deducted from Common Equity Tier 1 capital:
  - DTA associated with accumulated losses; and
  - DTA (excluding DTA associated with accumulated losses), net of DTL
    - Where the DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess shall neither be adjusted against DTA associated with accumulated losses nor added to Common Equity Tier 1 capital
- Application of these rules at consolidated level would mean deduction of DTAs from the consolidated Common Equity which is attributed to the subsidiaries, in addition to deduction of DTAs which pertain to the solo bank

From a bank's perspective, the two key areas for deferred tax are **loan loss provisioning** and **investment depreciation** – discussed in following slides

Loan loss provisioning

Section 36(1)(viia): Provision for bad and doubtful debts

- 7.5% of gross total income
- 10% of aggregate average rural advances

Section 36(1)(vii): Write-off of bad debts

- Deduction available to the extent write-off exceeds previous claims under section 36(1)(viia)

Issues

- Can loan loss provisions be claimed as tax deductible under section 36(1)(vii)?
  – Supreme Court judgment in the case of Vijaya Bank v. CIT (323 ITR 166)
- Can provision in respect of standard assets be claimed under section 36(1)(viia)?

Loan loss provisions typically give rise to creation of DTA

Investment depreciation

HTM securities	AFS and HFT securities
• HTM securities to be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity • Tax issues – Stock-in-trade or capital asset? – Deductibility of premium on amortisation – If stock, can securities be valued at lower of cost and market value?	• Marked to market – Valued scrip-wise and depreciation / appreciation aggregated for each classification – Net depreciation, if any, to be provided for; net appreciation, if any, should be ignored • Tax issues – For tax purposes, can securities be valued scrip-wise without aggregation for each classification?

Depending on position taken for tax purposes, investment depreciation could give rise to creation of DTL / DTA or could be neutral

Minimum alternate tax [MAT]

- MAT rate increased from **8.42%** in 2005-06 to **20.96%** at present
  - Increasingly taxpayers coming within the purview of MAT
- Applicability of MAT to banks
  - P&L in accordance with the Banking Regulation Act, 1949
  - MAT provisions amended in 2012 to cover banks

MAT

- MAT provisions amended in 2009: provision for diminution in value of asset to be added
  - Retrospective from 2001
- Significant provisions by banks
  - Loan loss provisions
  - Investment depreciation

  To be added back for MAT?
- No specific provision under law to claim deduction for write-offs if provision disallowed

Typically MAT may not apply in the normal course; MAT provisions may however be triggered when significant tax claims made in the return

Concluding Remarks

Concluding remarks

- RBI has always kept in focus the financial stability objective
- Minimum capital adequacy ratio in India is 9% as compared to 8% as per Basel norms and remains the same under Basel III
- Restrictions on Inter Bank liabilities to keep a check on inter-connectedness within banking system
- Measures for early recognition of financial distress
- Improvements in current restructuring process
- Incentives for lenders to agree collectively and quickly to resolution plans
- More expensive future borrowing for borrowers who do not co-operate with lenders in resolution.

Concluding remarks

The global accounting standards and guidelines as issued by the Institute of Chartered Accountants ('ICAI'), Reserve Bank of India ('RBI'), International Accounting Standard Board ('IASB') and US Financial Accounting Standards Board ('FASB') differ significantly in areas that affect the component's of a Banks:

- Tier I capital
- Risk Weighted Assets
- Capital Ratios
- Taxation (in general)

The Basel III accord is being considered at the same time when ICAI is mulling a proposal for convergence to IFRS from April 2016.

Ideally, the RBI and the accounting standard setters would need to coordinate the timing of mandatory adoption of these standards that would eliminate or minimise the effect of any inconsistencies in their guidance except where necessary to reflect different objectives and audiences (for example , approaches to valuations and provisions).

From a tax perspective, the key two areas are:

- Issuance of capital instruments: Tax issues in India will depend on the nature of capital instruments issued by banks
- Deferred tax: DTA needs to be deducted from Common Equity Tier 1 capital; banks may consider relooking at their deferred tax position, especially in relation to loan loss provisioning and investment depreciation

The consequent impact under Basel III due to differences in accounting and tax treatment applied by banks in different geographies based on different legislations would vary accordingly.

Thank You

This material is prepared for CAFRAL conference held on 4 July, 2014 and shall be used for used only for the stated purpose. The information contained herein is meant for general purposes and is not an exhaustive treatment of such subject(s) and accordingly is not intended to constitute professional advice or services. The information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

Any use of the information in this material is solely the readers personal responsibility and no entity whosoever shall be responsible for any loss due to reliance on this material