New liquidity and capital requirements

Kristin Gulbrandsen

Equity Certificates Seminar, 15 September 2010

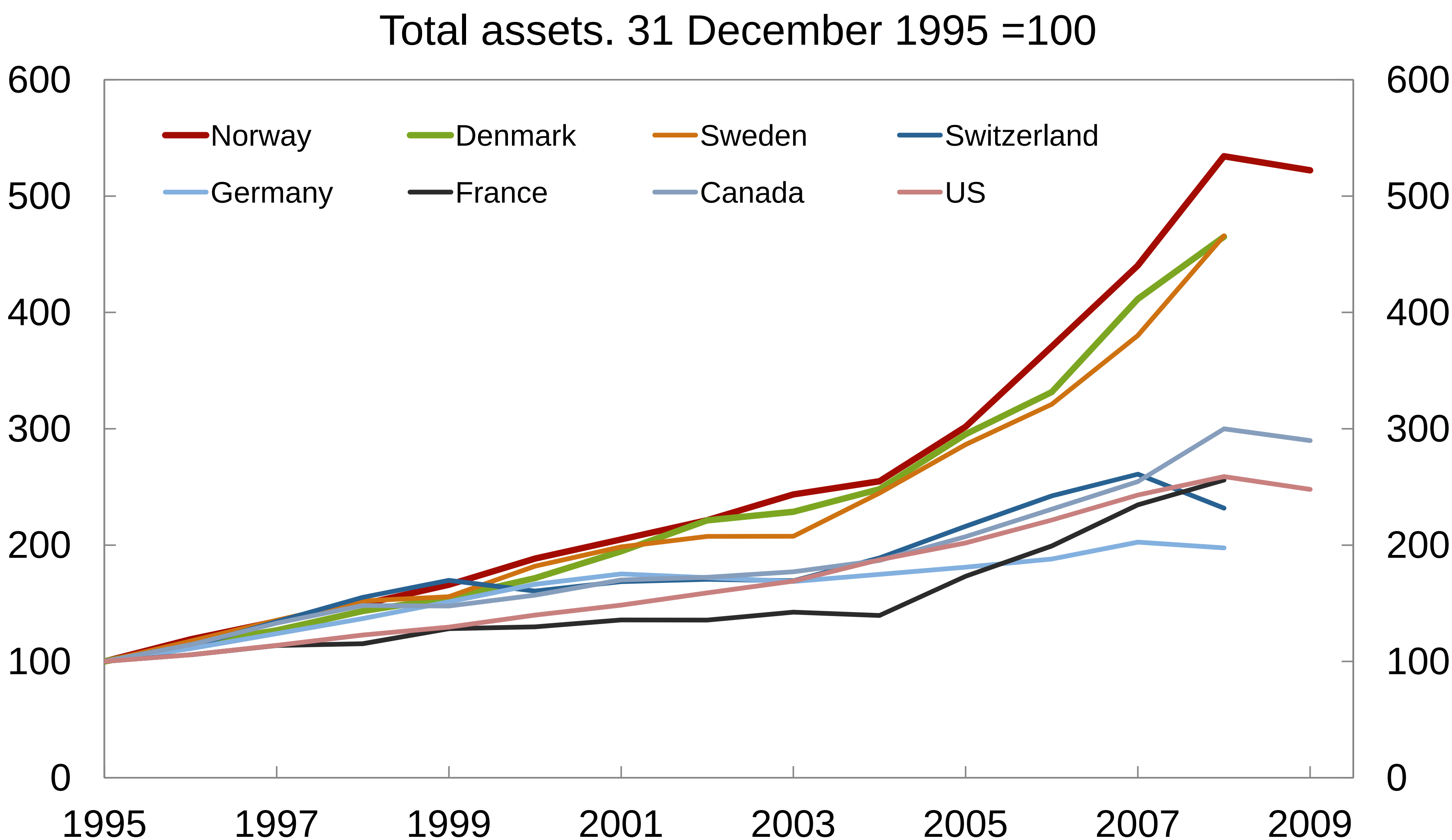
Somewhat tighter regulation would have net social benefits

- Costs from stricter regulation will likely be modest

- More capital and liquidity in banks lower the probability of new crises

Source: Analysis published by the Basel Committee 18 August 2010

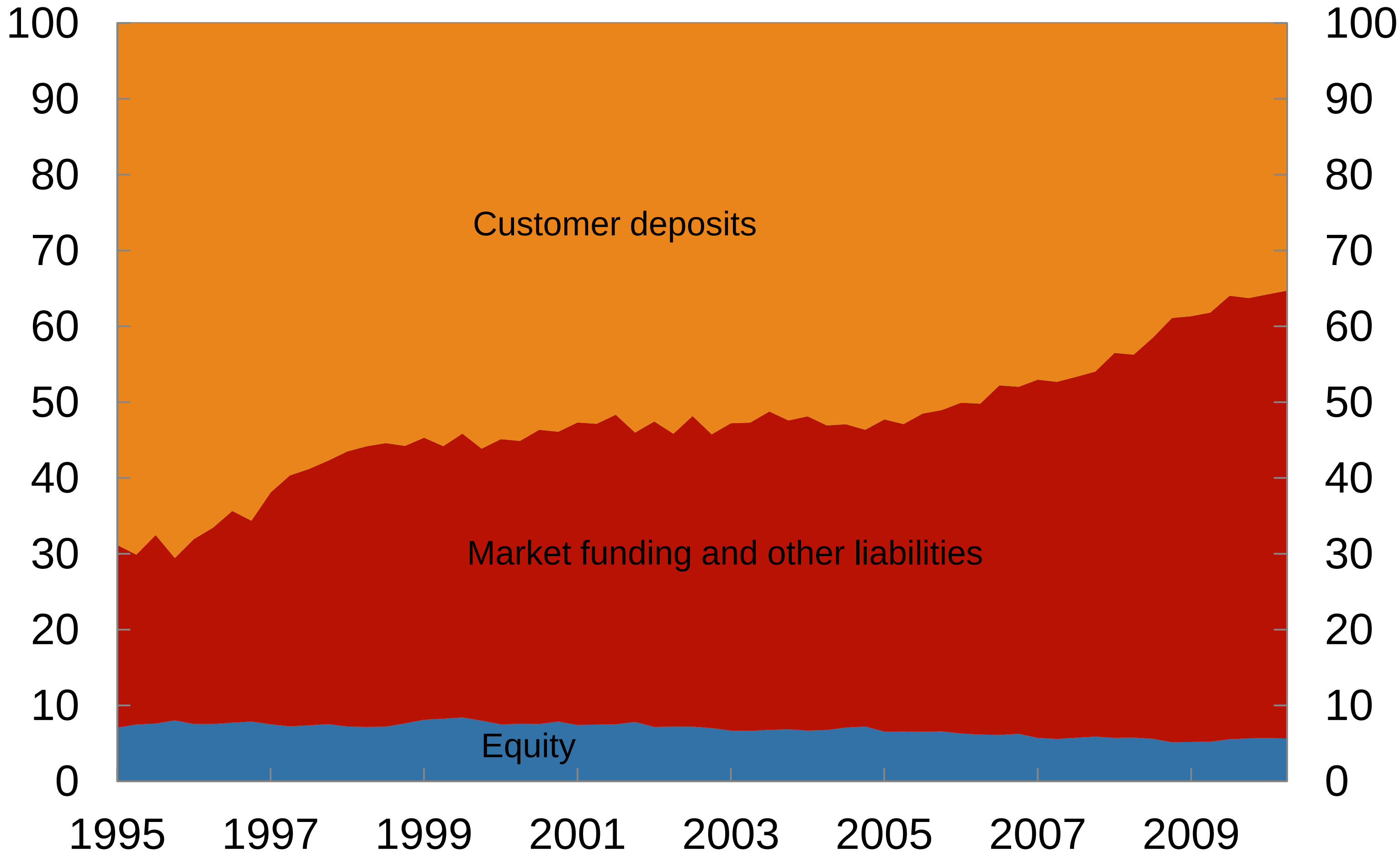
Strong growth in banks' balance sheets



Source: OECD Bank Profitability Statistics

Market funding has grown in importance

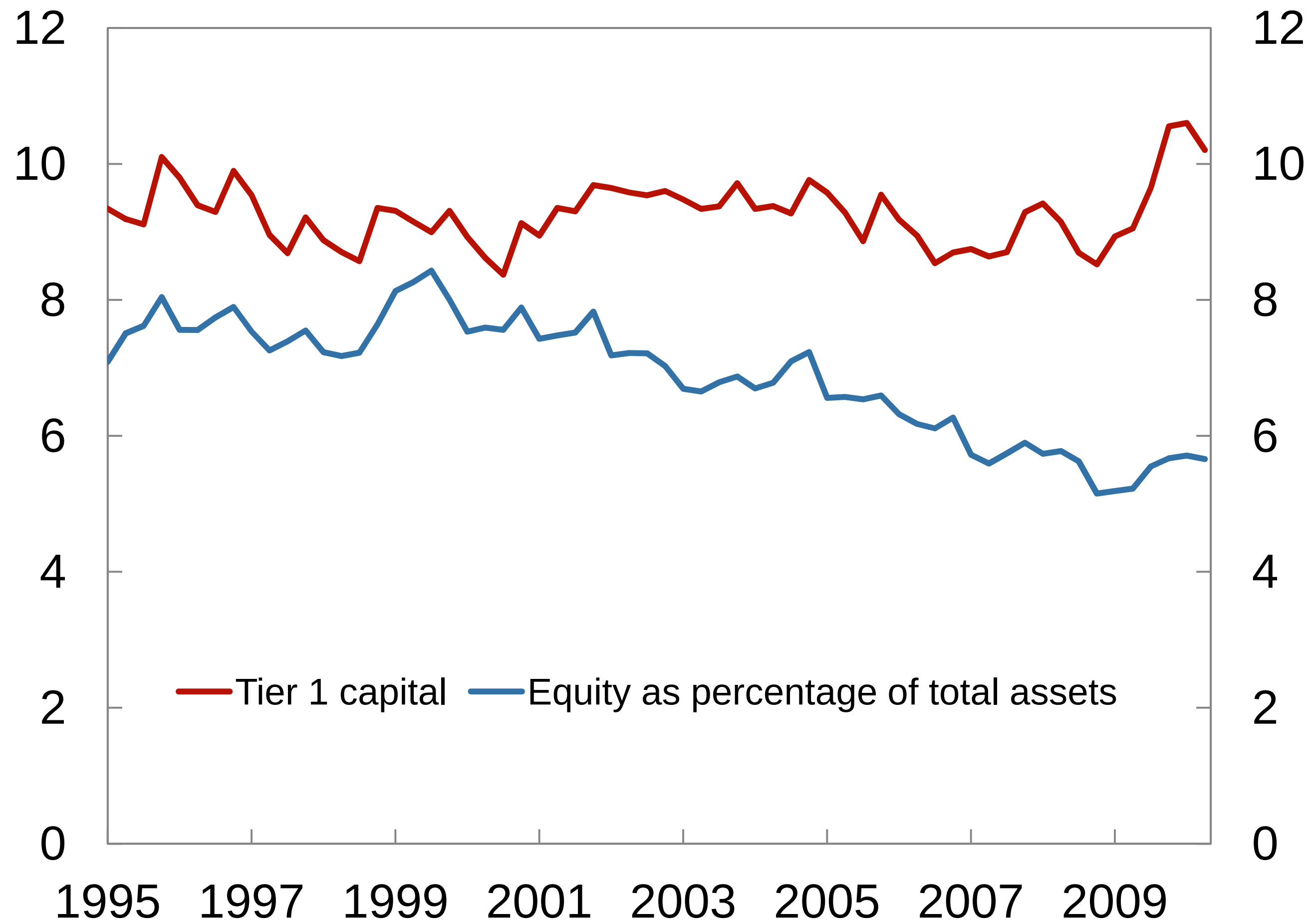
Funding sources for Norwegian banks and covered bond mortgage companies. Percentage of total assets



Source: Norges Bank

Equity and Tier 1 capital

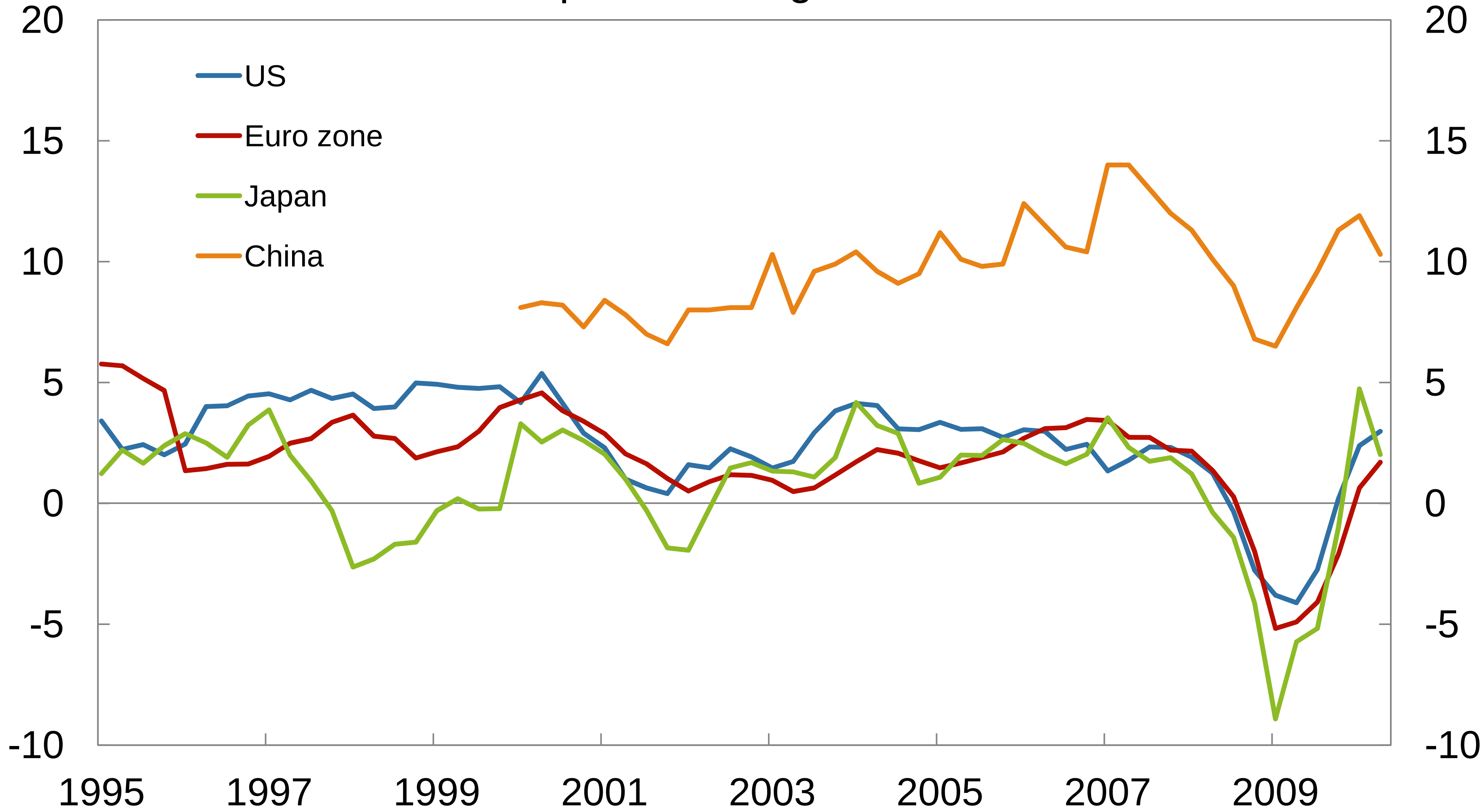
Per cent. Norwegian banks and covered bond mortgage companies



Sources: Norges Bank and Finanstilsynet (Financial Supervisory Authority of Norway)

High cost of financial crises

GDP. 4-quarter change. Per cent



Source: Thomson Reuters

The process

- Dec 09: Proposal from the Basel Committee
- Feb 10: Proposal from the EU Commission
- April: Response to consultations
- May: Bank data for quantitative impact studies
- July: Revised proposal from the Basel Committee
- Aug: Macroeconomic impact
- Sep: Calibration and phase-in arrangements
- Nov: G20 Summit in Seoul

Target: Nearly all parts of the reform package ready by year end

Proposals for more capital and liquidity

- Higher capital adequacy requirement and new non-risk-based leverage ratio requirement
- Strengthen quality of Tier 1 capital
- Build up buffers in good times that can be drawn on in periods of stress
- Regulation of systemically important banks more stringent than for other banks
- More liquid assets and more stable funding

Timetable

- Gradual phase-in 1 Jan 2013 – 31 Dec 2018
- Quicker phase-in possible in Norway
- Some countries are already ahead

Proposals for quantitative liquidity requirements

1. Liquidity coverage ratio ≥ 100 %
   - requiring liquid assets

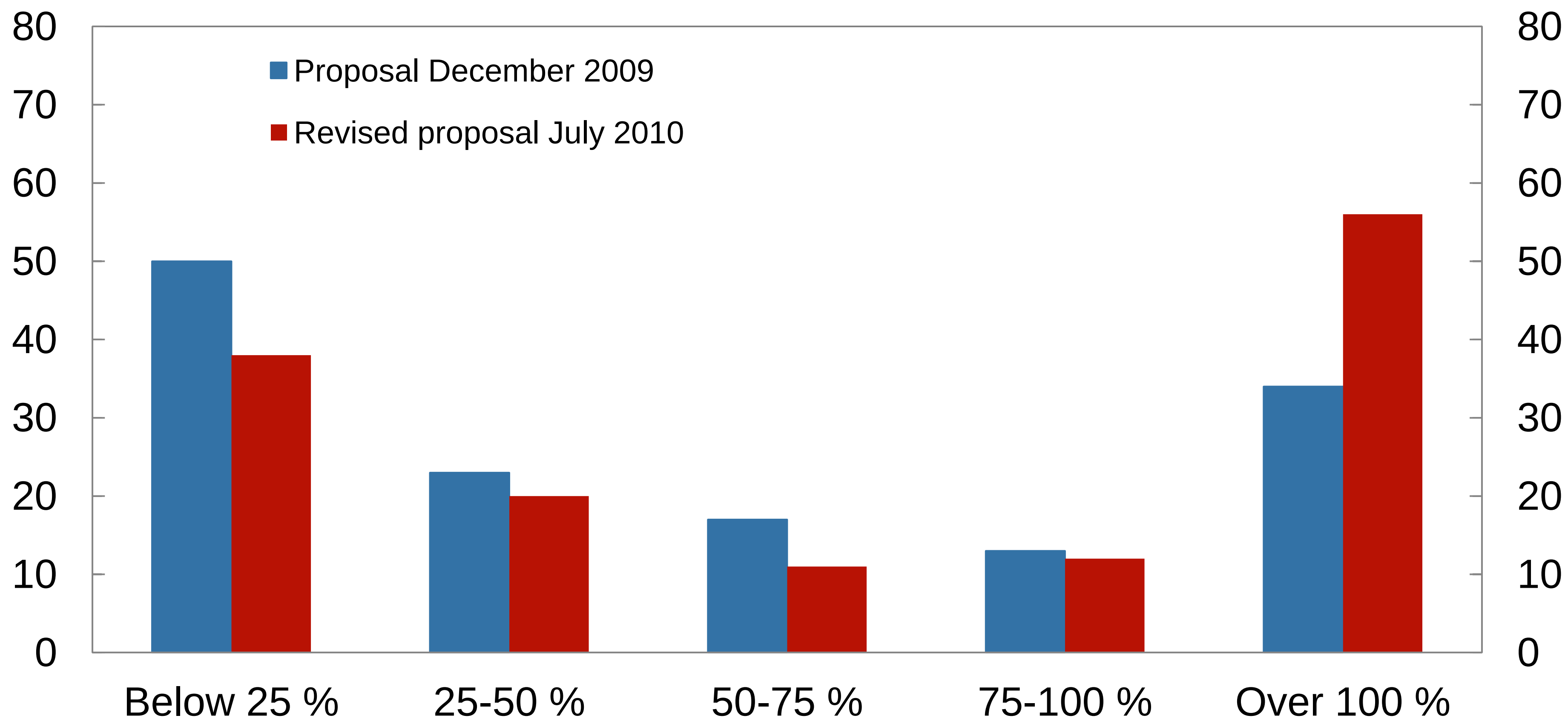
2. Net stable funding ratio > 100 %
   - requiring stable funding

"Liquidity Coverage Ratio": Banks must withstand 30 days of liquidity stress

- December 2009 proposal:
  - Narrow or broad definition of liquid assets
  - Substantial deposit run-off
- Revised proposal July 2010:
  - Broad definition of liquid assets
  - Less deposit run-off
  - Announcing separate rules for jurisdictions with small government securities markets
- September 2010:
  - Requirement effective as of 2015

Many Norwegian banks have limited liquidity

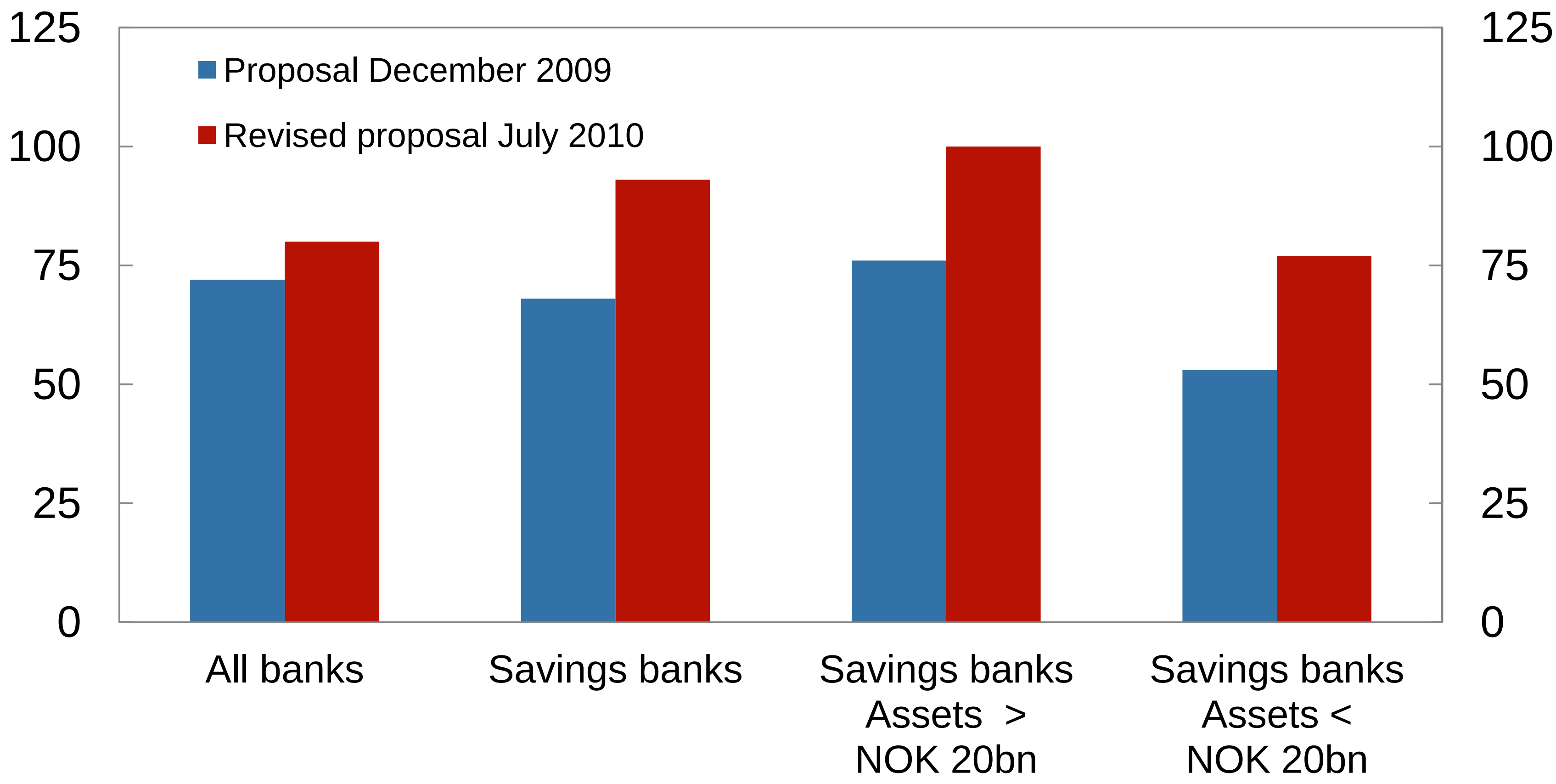
Banks' liquid assets as a percentage of required liquid assets
Number of banks. 31 December 2009



Source: Norges Bank

Small savings banks have limited liquidity

Banks' liquid assets as a percentage of required liquid assets
Average for the group. 31 December 2009



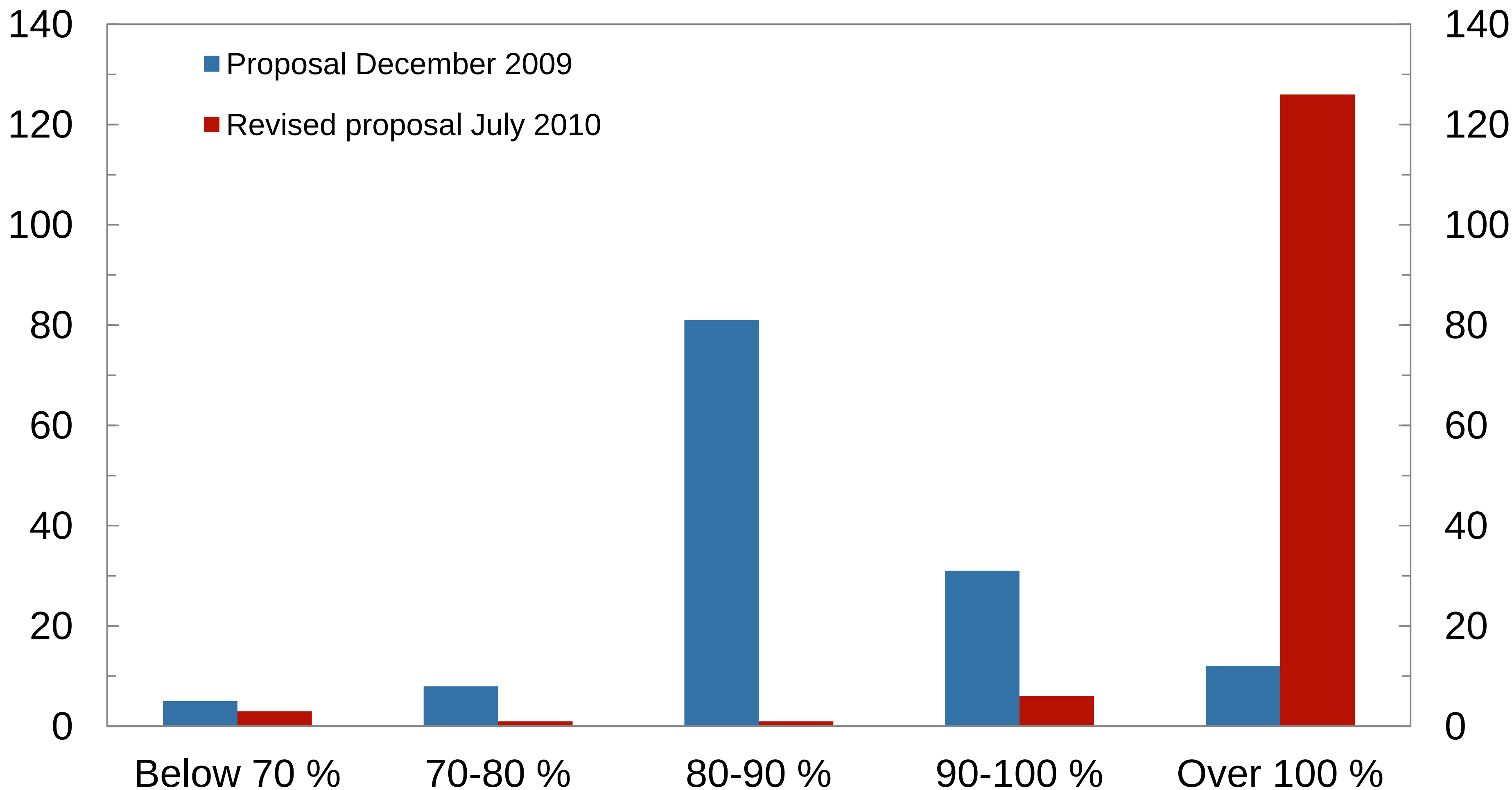
Source: Norges Bank

“Net stable funding ratio”: Stable funding of illiquid assets

- Proposal December 2009
  - Stability means long maturities ($\geq$ 1 year) or expected to be stable in periods of stress
- Revised proposal July 2010
  - Less deposit run-off
  - Secure residential mortgages need less stable funding
  - To be introduced in 2018

Most banks meet revised proposal

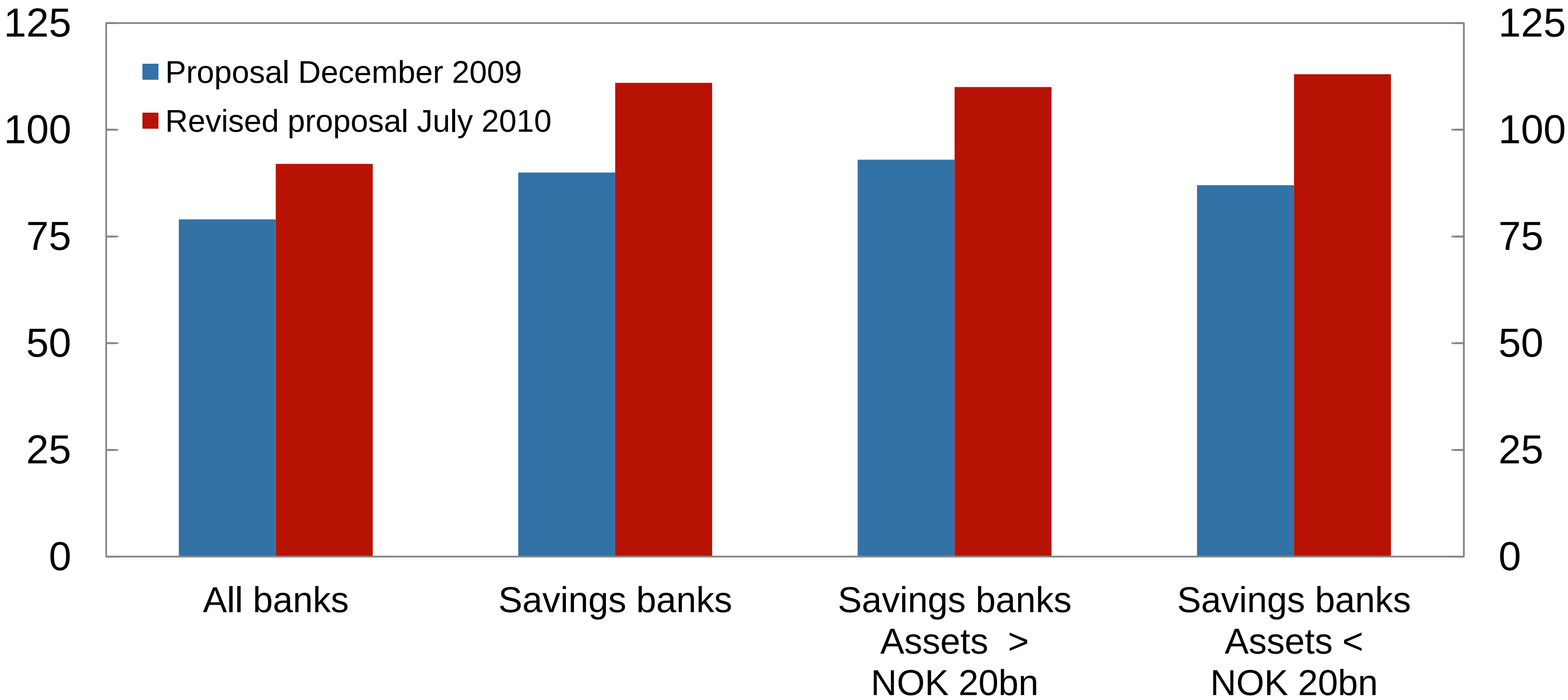
Banks' stable funding as a percentage of required stable funding
Number of banks. 31 December 2009



Source: Norges Bank

Savings banks in a strong position

Banks' stable funding as a percentage of required stable funding
Average for the group. 31 December 2009



Source: Norges Bank

Possible adaptations to liquidity requirements

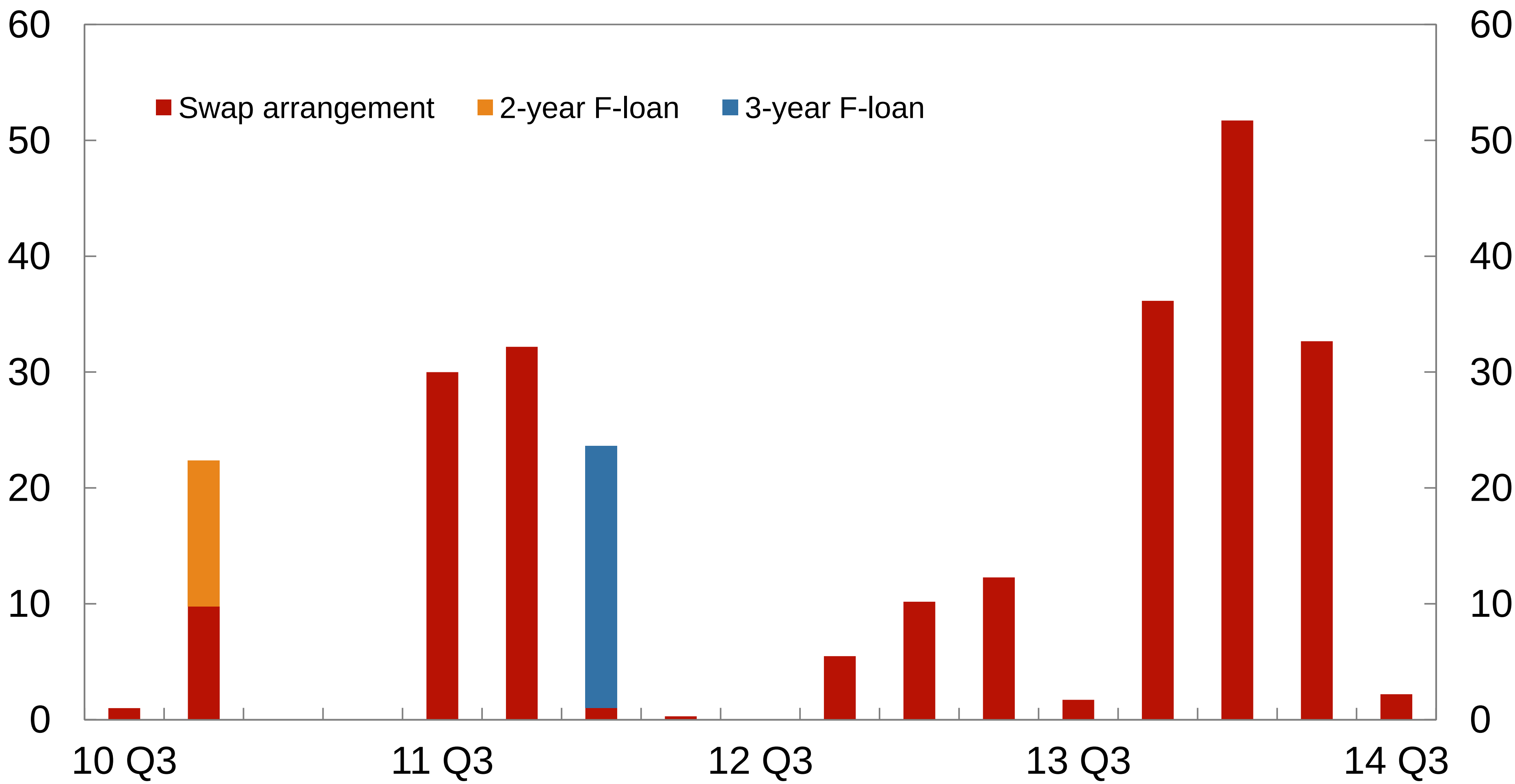
- Hold more government securities: Norwegian and foreign
- More long-term market funding
- Deposits with fixed maturities
- Securitise loans (covered bonds)
- More liquid covered bond markets
- Sell illiquid assets
- Shorten loan maturities
- Lower loan-to-value ratios for residential mortgages

Other factors posing challenges to banks' liquidity and funding

- Refinancing swap arrangement and longer-term F-loans
- New collateral requirements for loans from Norges Bank
- Changes in rules for money market funds
- Solvency 2 for insurance undertakings

Maturity profile of the swap arrangement and longer-term F-loans

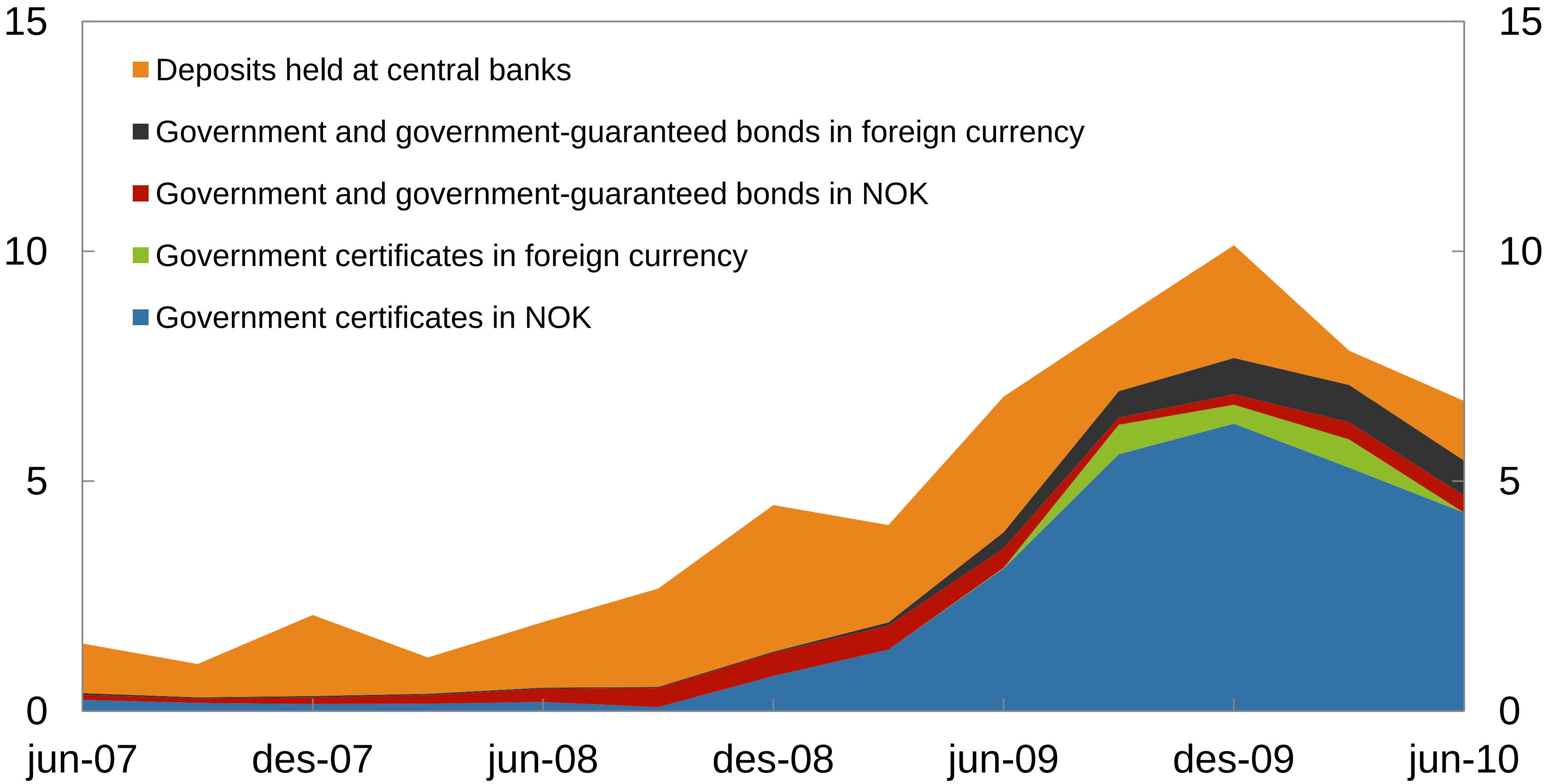
In billions of NOK



Source: Norges Bank

Swap arrangement has supplied liquid assets

Norwegian banks' most liquid assets. Percentage of total assets



Source: Norges Bank

The capital proposals: Overview

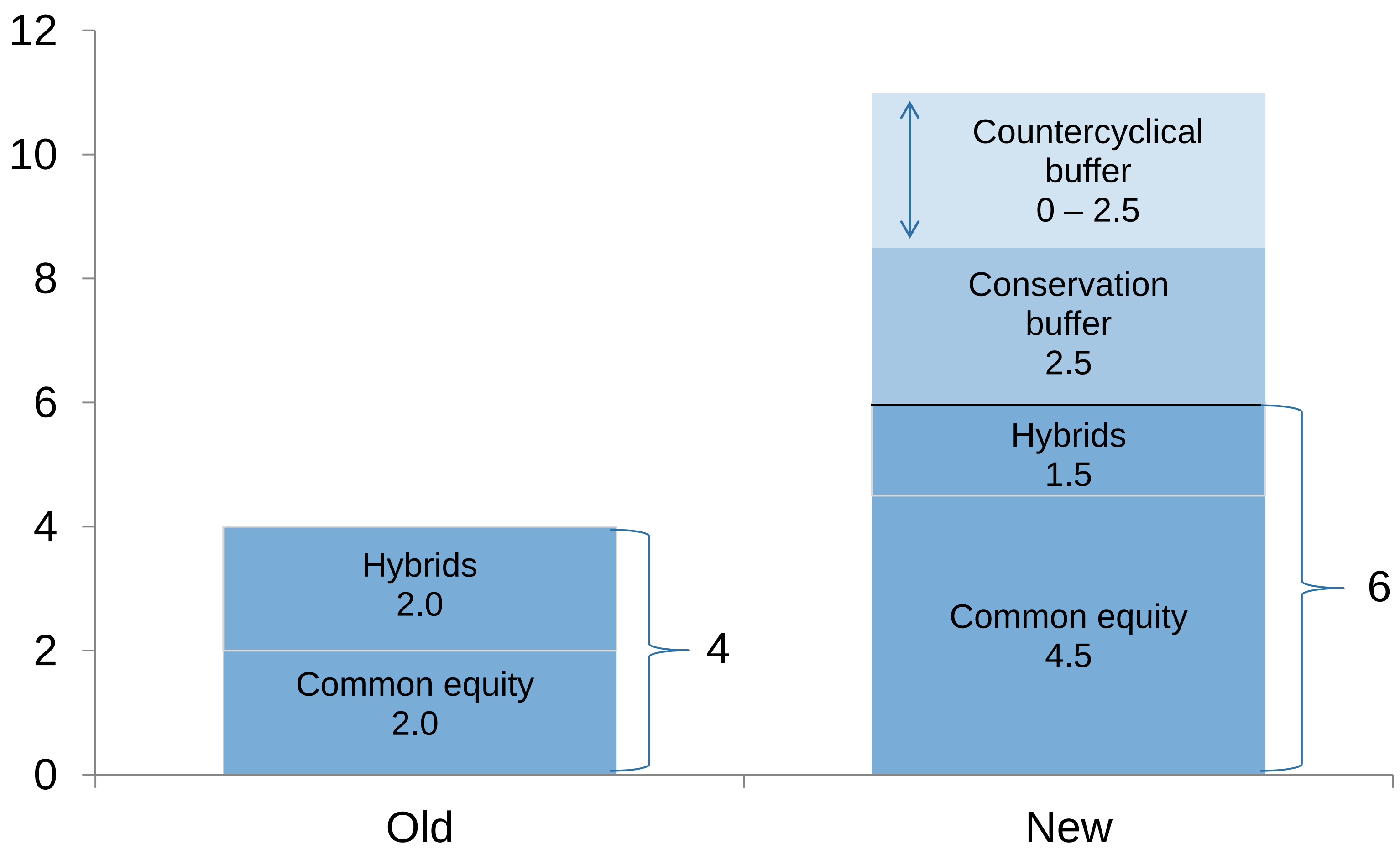
1. Capital base
2. Higher capital requirements
3. Counteract procyclicality
4. Leverage ratio
5. Systemically important institutions

Capital base - Tier 1 capital requirement

- December 2009 proposal
  - Tighten deductions in Tier 1 capital
  - Increase loss absorption for hybrid capital
- Revised proposal July/September 2010
  - Ease tightening of deductions
  - Deductions to be phased in later: 2014
- Relatively modest effect on Norwegian banks as Norwegian rules are already strict

More Tier 1 capital

Tier 1 capital requirement in percentage of risk-weighted assets



Capital buffers beyond minimum requirement

- Fixed capital buffer (conservation buffer)
- Countercyclical buffer on top of fixed buffer
  - Build up when credit growth high
- Cross-border banks apply weighted average of national buffer requirements
  - Bank subsidiary in host country holds local buffer
  - Branch in host country holds buffer in home country
- National authorities decide when to reduce or remove countercyclical buffer

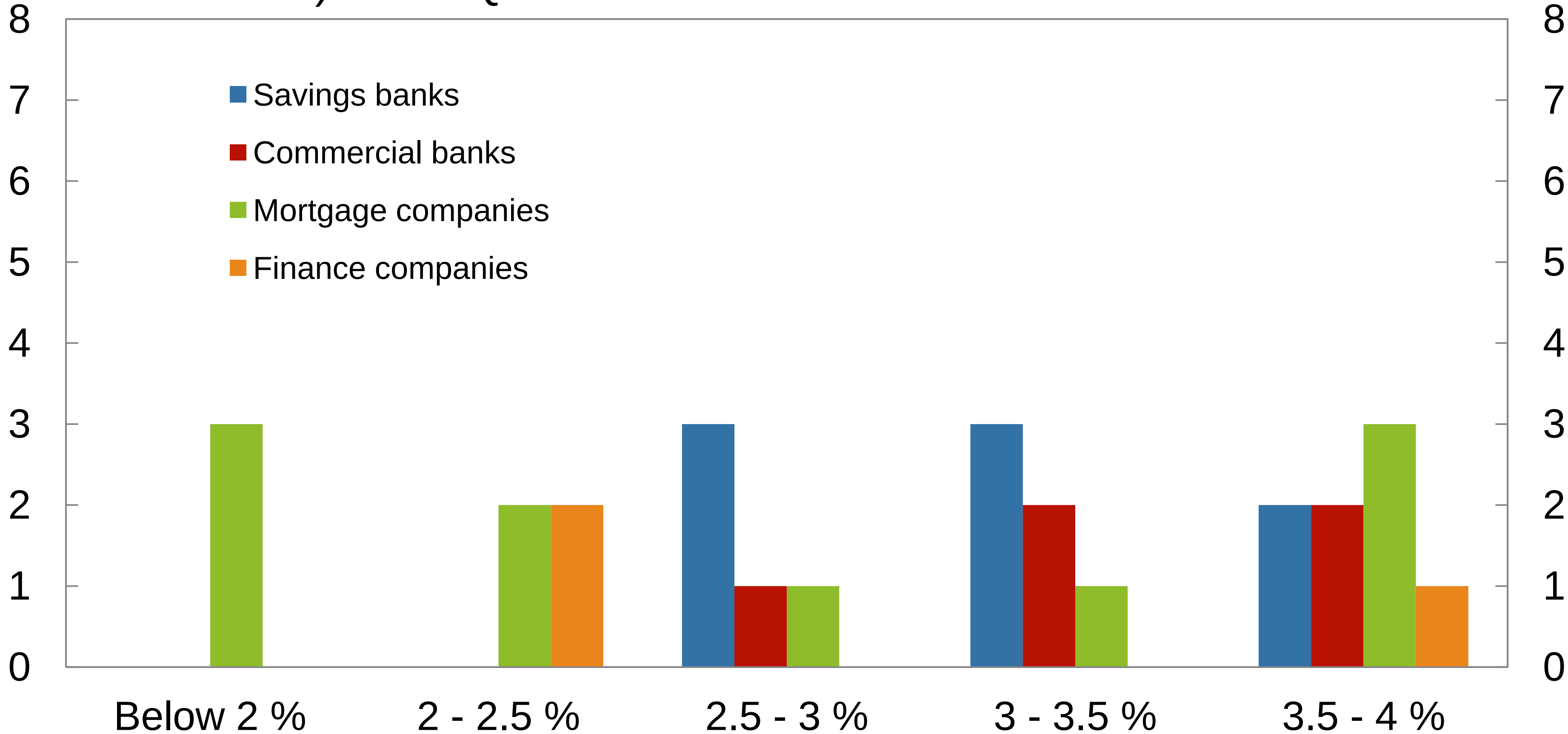
Leverage ratio

- Proposal December 2009:
  - Numerator: Tier 1 capital or common equity
  - Denominator: Total assets + off-balance sheet exposure

- Revised proposal July/September 2010:
  - Consider 3% as of 2018. Calculated as average over a quarter
  - Numerator: Tier 1 capital
  - Banks to start disclosing leverage ratio in 2015

Impact of a 3% leverage ratio

Number of financial institutions in Norway by equity ratio (equity as a percentage of non-risk weighted assets, including items not recognised on balance sheet). 2009 Q1



Source: Finanstilsynet (Financial Supervisory Authority of Norway)

Systemically important financial institutions

- Basel proposal December 2009 – not very specific
  - Higher risk weights for exposure to large institutions
  - Develop methods for measuring systemic importance
  - Consider strengthening capital and liquidity requirements
- FSB June 2010: General principles (interim)
- Basel proposal July 2010
  - Develop approach for setting more strict requirements for systemically important banks
- A good regime for crisis resolution is vital
  - Increased risk of loss for equity holders and creditors
  - In particular a challenge for cross-border institutions

Conclusion

- No doubt requirements will be more stringent than existing ones, but harsh enough to prevent future financial crises?
- Norwegian banks have a good basis and should adjust early to the new requirements
- New rules may make running a bank somewhat more expensive
- Better regulation will undoubtedly benefit the economy's stability and long-term growth

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