CHEAT SHEET

FINALIZED BASEL III FRAMEWORK & REVISED PILLAR 3 DISCLOSURE STANDARD

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Pillar III
Revision Phases

In December 2017, Basel Committee on Banking Supervision (BCBS) completed its journey of finalizing Basel III post-crisis regulatory reforms. The reforms, originally introduced in 2010 as the aftermath of the (Global Financial Crisis) GFC, underwent multiple phases of discussions and negotiations, before finally rolled out for implementation with deadlines leading up to the 3rd decade of the century.

The finalized Basel III norms are widely expected to help banks implement 360-degree approach in managing their capital adequacy, risk and liquidity mandates while also operating within the prescribed leverage limits vis-à-vis their high quality capital reserves (CET1).

Following-up on the major changes and updates introduced in Basel III, Basel Committee also took phased approach in revising the Pillar III disclosure requirements to better align with newly introduced as well as revised approaches.

Since the introduction of Pillar III disclosure requirements in Basel II in 2004, BCBS largely brought in changes in 3 phases commonly known as:

Phase 1	January 2015 Standards
Phase 2	March 2017 Standards
Phase 3	December 2018 Standards

We will dive deeper into the recently introduced wave of changes in Phase 3, however, for the sake of maintaining the chronological sanctity of the Pillar III revisions; let's also have a brief look at the major overhauls undertaken in Phase 1 & Phase 2:

Phase 1
January 2015 Standards

The first phase mainly focused on ensuring comparability and consistency in disclosures by banks across the board. The revised disclosure requirements were able to strike a fine balance between fixtures of templates that brought in comparability while also leaving enough room of flexibility for senior management in providing commentary in their own language about bank's risk profile. The phase 1 disclosure achieved so by introducing hierarchical disclosure regime where the quantitative reporting forms surrounding capital adequacy were fixed to ensure consistency and comparability across banks whereas for disclosures important for markets (yet not core to capital computation) were kept flexible. This approach also allowed room to accommodate management commentary on bank's particular circumstances and risk profile.

Phase 2
March 2017 Standards

Phase 2 revisions were introduced during transitionary phase of banking regulatory regime from Basel II to Basel III. Although, the Basel norms were being implemented in waves across the globe, yet Phase 2 of Pillar III updates, brought in consolidation of all the newly introduced risk measures in Basel III (and beyond) namely; disclosures surrounding composition of capital, the leverage ratio, the liquidity ratios, the indicators for determining globally systemically important banks, the countercyclical capital buffer, interest rate risk in the banking book as well disclosures pertaining to remunerations. The Pillar 3 updates after Phase 2 also incorporated revised market risk framework and newly introduced G-SIBs' regulatory capital mandates in the form of Total Loss Absorbing capacity (TLAC).

Another highlights of revised Pillar 3 disclosures in Phase 2 was the introduction of dashboard type disclosure templates to capture summary of banks' key prudential metrics depicting its prudential position and key RWA break-ups across asset classes and adopted computational approaches.

Phase 3
December 2018 Standards

After the finalization of Basel III norms in December 2017 that introduced massive changes and additions to existing risk measures; it was imperative for the committee to revise Pillar 3 disclosure requirements to reflect underlying Basel updates. Subsequently, the committee requested comments for consultation in Feb 2018 and formally released the finalized disclosure requirement in December 2018.

Barring the minimum changes expected due to RWA computation approaches across asset classes and revisions to other risk measures; the newly revised Pillar 3 disclosure requirements also covers the following glaring inclusions:

- disclosure of bank's encumbered and unencumbered assets
- introduction of capital distribution constraints to portray clearer picture of bank's capital position.

Let us dive deeper into the major changes introduced in Phase-3.

Changes Induced due to Finalized Basel III

This section briefly captures the major revisions/additions undertaken in finalized Basel III norms in December 2017 and the corresponding updates made to Pillar 3 disclosure standard.

Credit Risk

Standardized Approach (SA)

Under this approach, banks rely upon the risk weights set by the respective supervisor to compute their risk-weighted assets.

With the finalized norms, the committee has tried to reduce excessive reliance of banks on external credit ratings and also enhance risk sensitivity by providing more detailed risk weight assignment criteria for certain asset class.

Considering the fact that output of SA will also act as a base for the calculation of newly introduced capital floor, therefore, the importance of these changes increases multi-fold in many ways.

At a higher level, the risk-weight chart for the following asset classes/exposure types has undergone major changes:

1. Exposure to banks will see recalibration in risk-weights where the unrated exposures shall be treated as per what is called Standardised Credit Risk Assessment Approach (SCRA).
2. Exposure to corporates will be risk-weighted with the more granularly defined Risk Weight (RW) chart. Specific risk-weights have now been introduced for exposure to SMEs. Barring real-estate exposure, the specialised lending asset class i.e. project, object and commodities finance will now be treated as per separately defined risk-weight table that is more aligned with exposure to corporates while also considering exposures' operational phase where issue specific ratings do not exist.
3. Residential Real Estate Exposures will now be risk-weighted on the basis of LTV ratio while the commercial real estate has also undergone major overhaul with more granular charting of RW assignment.
4. The other retail exposures have been further distinguished into revolving & transactional exposures and the RW chart is thus granulised accordingly.
5. The subordinated debt exposures alongside equity exposures have also undergone for more granularity in RW assignment.
6. With respect to off-balance sheet items, the credit conversion factors (CCF) for unconditionally cancellable commitments (UCCs) have been introduced for the first time. Previously taken as zero

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Following are the disclosure template that have undergone changes to accommodate revised SA approach are:

Template **CR4** (SA – credit risk exposure and credit risk mitigation effect)

Template **CR5** (SA – exposures by asset classes and risk weights) have been amended to reflect the addition of new asset classes (e.g. introduction of specialized lending asset classes) and updates to risk weights under the revised SA.

To provide greater consistency with existing disclosure of credit conversion factors (CCF) for the IRB approaches in the existing Template **CR6** (IRB – Credit risk exposures by portfolio and PD range), Template **CR5** has also been enhanced to include disclosure requirements for CCF under the SA.

Internal Risk Based Approach (IRB)

Internal models have always been a keen area of discussion both for banks as well as regulators. While banks have been able to reduce their capital requirement by using sophisticated models, yet, regulators have often been seen lagging in demystifying the ever complex models created by banks.

Moreover, the committee identified numerous flaws leading to undesired consequences due to adoption of internal models. It was also noted that usage of excessively complex model often leads to disparity in comparison of capital ratio among peer banks.

As a result, the committee has added constraints to usage of internal models while also providing floors & further guidance on estimation of risk parameters (PD, LGD & EAD):

1. **Internal models usage restrictions:** The constraints have been put on the exposures/ asset classes for which Advanced-IRB approach can be adopted. Certain asset classes have been completely restrained from adopting any IRB approach and hence, can only compute RWA using Standardised Approach:
   - Equity exposures will only be treated as per Standardised Approach. Modelling approach for Equity asset class has been removed completely.
   - The A-IRB approach cannot be adopted for exposure to corporates with consolidated revenue of > € 500M.
   - A-IRB approach is also unavailable for Banks and Other Financial Institutes whereas banks can still adopt IRB approach for Specialised Lending exposures.

2. **Introduction of Risk Parameter Floors:** While flooring for banks' computed IRB parameters existed in Basel II guidelines as well; yet, the newly introduced floors along with the recalibration of those existing previously, will bring in the much needed conservatism in estimation of risk parameters and thereby, reducing the variability in capital requirements. The floors will apply to the calculation of PD under F-IRB and PD, LGD and EAD for banks under A-IRB:

- **Probability of Default (PD) Floors:** 5 Basis Points for exposures to Corporate, Retail: Mortgages, QRRE (Transactors) & Others. 10 basis points for QRRE (Revolvers) exposures.
- **Loss Given Default (LGD) Floors:** On the lines on Basel II, the LGD floors can broadly be differentiated based on secured and unsecured portion of exposure. Corporate Asset Class: All unsecured exposures shall be subjected to floors of 25% whereas flooring for the secured portion would be assigned on the basis of collateral type. The range of LGD for secured loans will vary from 0 to 15%. Retail Asset Class: Unsecured LGD ranges from 30 to 50% where lower level applicable to Other Retail exposure class only. Range & criteria of LGD floors for secured loan remains same as that of Corporates with the only exception for mortgage loans where floor exists at flat 5%.
- **Exposure at Default:** For asset class where EAD modelling is still available, the exposure value of a bank under IRB approach cannot be lesser than sum total of: (a) On-balance sheet exposure; (b) 50% of the off-balance sheet exposure using the applicable Credit Conversion Factor (CCF) as per the standardised approach.
- **Removal of Scaling Factor:** With the introduction of additional floors to risk parameters and recalibration of the existing ones, the committee has done away with the existing scaling factor of 1.06 from Basel II. The scaling factor was used for adjusting capital requirements arising from internal models.

Template **CR10** (IRB – specialized lending and equities under the simple risk weight method) has been amended to remove the disclosure of equity exposures under the IRB approach's simple risk weight method because such exposures can apply the SA only under the finalized Basel III framework.

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Additional Credit Risk Disclosures

Non-Performing Assets

A supplementary table has been introduced to assess bank's assets that are currently in delinquent state. The table can be mandated for disclosure at the discretion of supervisory bank and mainly comprises Non-Performing Assets (NPAs) data published across various asset class and product types. The published NPAs are required to be segregated in three categories:

- Defaulted exposures and/or impaired exposures;
- Exposures that are not defaulted/impaired but are more than 90 days past due; and
- Other exposures for which full repayment is unlikely.

The table also has a qualitative section for banks to provide commentary on their problem-assets including NPA definition, exit criteria etc.

RWA Comparison – Credit Risk

As per the newly introduced flooring norm in finalized Basel III guidelines, banks' calculations of RWAs generated by internal models cannot, in aggregate, fall below 72.5% of the risk-weighted assets computed by the standardized approaches. This limits the benefit a bank can gain from using internal models to 27.5%. It additionally helps maintain a level playing field among banks using internal models and standardized approaches, thus, limiting the variability of risk weighted assets and enhancing credibility in the banking regulation machinery.

In order to gain more visibility to compare RWA computed under Standardized as well as IRB approach, the new templates, **CMS1 & CMS2** have been incorporated in Pillar 3 disclosures. Banks are expected to explain the main drivers of difference (e.g. asset class or sub-asset class of a particular risk category, key assumptions, underlying parameter estimations, national implementation differences) between the internally modelled RWA disclosed that are used to calculate their capital ratios and RWA disclosed under the full standardized approach that would be used should the banks not be allowed to use internal models. In addition, banks must disclose more granular information related to the calculation of their risk-weighted assets under internally-modelled and standardized approaches.

Operational Risk

In finalized Basel III norms, BCBS acknowledged the inadequacies that existed within operational risk framework. The committee also pointed out the instances when capital requirements for operational risk proved insufficient to cover losses incurred by some banks. Furthermore, the committee noted that in past, internal models have often fallen short of computing adequate capital especially while factoring-in major loss events such as misconduct, inadequate system controls etc.

In pursuit of introducing simplicity & uniformity to capital adequacy derivation approach, Operational Risk framework has undergone major changes with the committee extinguishing internal models (Advanced Measurement Approach) as well as the other three standardized approaches and replacing them with single risk-sensitive standardized approach to be used by all banks.

The newly introduced operational risk capital calculation approach is designed upon two underlying principles:

- Increase in operational risk is directly proportional to rise in bank's income;
- Banks that have experienced greater operational risk losses historically are assumed to be more likely to experience operational risk losses in the future.

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The aforementioned two components i.e. bank's income (called BIC-Business Indicator Component) and its historical losses (called IML-Internal Loss Multiplier) are the major inputs that would go into calculation of operational risk capital.

As anticipated, the Pillar 3 Operational Risk disclosure forms have undergone massive transformation. The committee has prescribed 4 forms in total to capture varied information:

ORA - General qualitative information on a bank's operational risk framework

OR1 – Historical losses

OR2 – Business indicator and subcomponents

OR3 – Minimum required operational risk capital

Leverage Ratio

Leverage Ratio (LR) was originally introduced in first draft of Basel III to complement the risk-weighted capital ratio with a non-risk based capital ratio; mainly to keep a watch on bank's excessive leverage building which proved to be one of the main catalysts of the financial crisis. The ratio limits any excessive build-up in leverage. Under this requirement, the Tier 1 capital of the bank must be at least 3% of the bank's on- and off-balance sheet exposures.

The Global Systemically Important Banks (G-SIB) would see major impact of Leverage Ratio on their capital requirements. With the finalised norms, BCBS has introduced a leverage ratio buffer exclusively for G-SIBs. The committee has further refined the exposure inclusions in calculating Leverage Ratio.

1. **G-SIB Leverage Ratio Buffer:** After introducing a risk-based capital buffer for G-SIBs, the LR buffer has been added to act as a backstop to the risk-based requirements for G-SIBs. The leverage ratio buffer for each G-SIB will be set at 50% of its risk-based capital buffer. For example, a bank with a 2% risk-based buffer will have a 1% leverage ratio buffer and so will be expected to maintain a leverage ratio of at least 4% i.e. the prescribed 3% as per LR rule and additional 1% from risk-based buffer.
2. **Refinement of Exposure Measures:** The committee has modified the ways in which derivatives are reflected in the exposure measure. The treatment of off-balance sheet exposures has also undergone changes to ensure consistency with their measurement in the standardised approach to credit risk.

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The revised standard on the basis of which, the disclosure templates have been updated, was introduced in March 2017. As a result, both the leverage ratio templates i.e. **LR1 & LR2** have been revised:

1. **LR1:** To capture the computational adjustments done on bank's assets (exposures) vis-à-vis financial accounting method to ensure reconciliation between Pillar 3 disclosures and financial statements.
2. **LR2:** To capture the split of each component that went into derivation of leverage ratio.

Credit Valuation Adjustments

The CVA risk framework was introduced as a result of lessons learnt from the previous financial crisis where deterioration in creditworthiness of a counterparty in a covered transaction (derivatives and securities financing transactions) was identified as the major source of losses for banks.

The committee, in December 2017 finalised norms, has introduced significant changes to the framework such as removal of modelling approach and addition of exposure component thereby, making it much more granular, simpler and holistic:

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Inclusion of Exposure Component: One of the missing components in existing CVA framework was the price of transactions. A crucial input that not only contributes in deriving risk capital charge but is also sensitive to fluctuations in underlying market risk factors. Therefore, the revised CVA framework will now take into account the exposure component of CVA risk along with its associated hedges.

Removal of Modelling Approach: Let's face it, when it comes to demystifying how the model is built and how it crunches numbers, the modelling approach for CVA was one of the toughest nut to crack. The committee observed that CVA as compared to other risks in a bank's trading book is much more complex and hence, cannot be modelled by banks in a robust and prudent manner. Consequently, the committee has removed internally modelled approach.

Two-and-a-half Approaches: The only approaches left are the recalibrated Basic (BA-CVA) & Standardised (SA-CVA) approach. Supervisor's authorisation would be required before adopting SA-CVA approach. In addition, a bank with an aggregate notional amount of non-centrally cleared derivatives less than or equal to €100 billion may calculate their CVA capital charge as a simple multiplier of its counterparty credit risk charge (the half approach a.k.a reduced basic approach). Given the recalibration of both the approaches, BA-CVA seems to be more in alignment with the standardised approach whereas SA-CVA is based on changes in fair-value vis-à-vis market risk factors thus incorporating volatility in calculation.

The committee received feedback on its previously introduced forms that the qualitative input parts may lead to mandating banks to share their sensitive proprietary information and therefore, some of the forms have been revised to particularly address the concern raised.

The pictorial break-up of Pillar 3 break-up requirements depending upon computational approach followed by the bank:

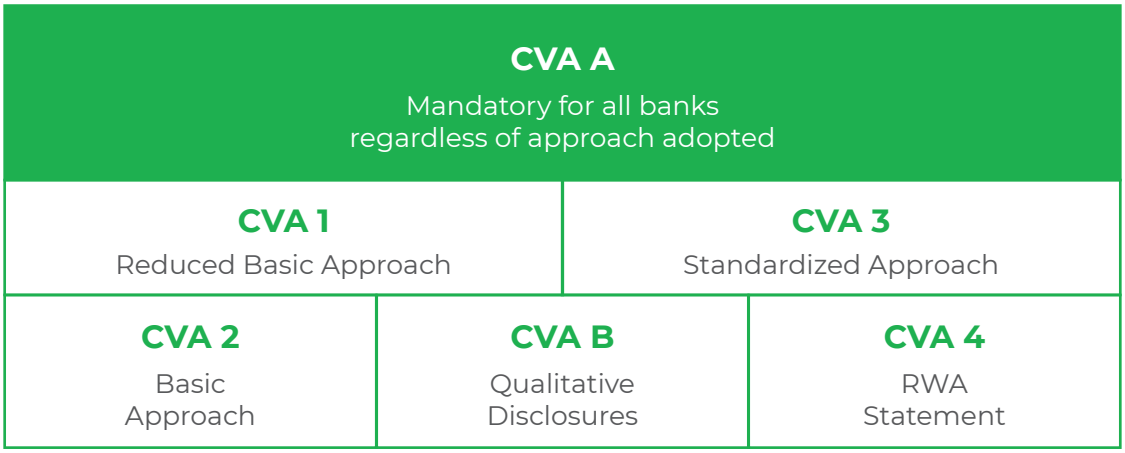

Table CVA A - General qualitative disclosure requirements related to CVA – The table is mandatory for all banks and requires a bank to provide a qualitative description of its risk management objectives and policies for CVA risk.

Template CVA 1 - The table is mandatory for banks having part or all of their CVA risk charges measured according to the reduced version of BA.

Template CVA 2 - The table is mandatory for banks having part or all of their CVA RWA measured according to the full version of BA-CVA.

Table CVA B (Qualitative disclosures for banks using the SA-CVA), **Templates CVA 3** (The standardized approach for CVA (SA-CVA) and **CVA 4** (RWA flow statements of CVA risk exposures under the SA-CVA) – This set of disclosures is mandatory for banks using the SA-CVA.

Overview of Risk Management, Key Prudential Metrics and RWA

Due to revision in Basel III methodologies two of the overview templates have also undergone changes under new disclosure standard.

Template OV1 - Overview of RWA – now revised for allowing disclosure pertaining RWA break-up for each asset (& sub-asset) class as per the computational approaches under finalized Basel III norms and also the corresponding capital requirement for each RWA line item.

Template KM1 - Key metrics - the standard has been updated to require the disclosure of (i) leverage ratios and (ii) the disclosure of capital ratios that exclude the output floor* in the computation of RWA.

** The revised output floor in Basel III framework, limits the capital benefit a bank can obtain from its use of internal models, relative to using the standardised approaches. As per the newly introduced flooring norm, banks' calculations of RWAs generated by internal models cannot, in aggregate, fall below 72.5% of the risk-weighted assets computed by the standardised approaches. This limits the benefit a bank can gain from using internal models to 27.5%. It additionally helps maintain a level playing field among banks using internal models and standardised approaches, thus, limiting the variability of risk weighted assets and enhancing credibility in the banking regulation machinery.*

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Asset Encumbrance

Asset encumbrance has particularly been of interest to assess accurate picture of a bank's asset. Encumbered assets are the assets that a bank is restricted or prevented from liquidating, selling, transferring or assigning due to legal, regulatory, contractual or other limitations. Encumbered asset could arise due to certain kind of transactions conducted by a bank, such as repurchase agreements, underlying asset pool for covered bonds, securities lending etc.

Any asset that does not meet the definition of encumbered asset can be classified as Unencumbered asset. on the other hand are exactly opposite of encumbered assets.

The newly introduced Pillar III disclosure **Template ENC,** requires banks to disclose information on their encumbered and unencumbered assets in separated columns.

Capital Distribution Constraints

Banks have consistently been raising capital by issuing subordinated capital instruments (CET1, AT1, T2) to meet Basel III capital requirements, i.e. minimum: 4.5% CET1, Capital Conservation Buffer (2.5% CET1), Countercyclical Buffer (2.5% CET1) and additional buffers for G-SIBs.

Because of the subordinated feature of these instruments, Basel Committee has released additional Pillar 3 template **(CDC)** to capture the capital ratio(s) below which capital distribution constraints are triggered as required under the Basel framework.

Banks are required to publish their current capital ratio comprising CET1 and additional buffer ratios mentioned above. This template will help market participants assess the capital levels of a bank vis-à-vis capital constraint trigger which in turn should indicate the likelihood of the capital distributions being restrained during stressed periods.

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